Supreme Court of the United States

OCTOBER TERM, 1965

No. 351

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

WALTER F. TELLIER, ET UX.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

INDEX

[fol. A]

IN THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

No. 28823

WALTER F. TELLIER AND EVELYN H. TELLIER, PETITIONERS

against

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

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EXCERPTS FROM APPENDIX TO PETITIONERS BRIEF—filed May 28, 1964

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* * * *

[File Endorsement Omitted]

[fol. 1]

DOCKET ENTRIES

BEFORE THE TAX COURT OF THE UNITED STATES

Docket No. 90189

Date	Filings and Proceedings
Dec. 6, 1960	Petition Filed: Fee Paid Dec. 6, 1960
Dec. 6, 1960	Request by petr. for trial at New York, New York
Feb. 3, 1961	Answer by resp. filed
Feb. 3, 1961	Request by resp. for trial at Newark, N. J.
Feb. 28, 1961	Reply filed by Petr.
Dec. 19, 1961	Notice of trial at New York, New York, March 19, 1962

Date	Filings and Proceedings
Mar. 2, 1962	Motion by petr. for continuance from March 19, 1962 trial calendar at New York, N. Y.
March 5, 1962	Notice of Hrg. March 19, 1962 New York, N. Y. on Petr's motion for continuance.
March 19, 1962	Hrg. before Judge Forrester—New York (Newark Session)
	Petr's Written Motion for Continuance—Granted
	Continued Generally.
March 29, 1962	Transcript of Hrg. March 19, 1962 rec'd
July 24, 1962	Notice of trial at New York, New York; Oct. 29, 1962
[fol. 2]	
Nov. 8, 9, 1962	Trial before Judge Scott—New York, N. Y. (Newark)
	Resp. Amendment to Answer filed and served 11/9/62
	Resp. Motion to Amend Answer (Obj. by Petr) Granted
	Resp. granted leave to Reply.
	Stip. of facts w/jt. exhibits
	Briefs due 1/8/63
	Reply Briefs due 2/25/63
	Submitted to Judge Scott
	Under Submission
Dec. 5, 1962	Reply to Amended Answer filed by petitioners.
Dec. 7, 1962	Transcript of proceedings of Nov. 8, 9, 1962 received. (1)
Dec. 21, 1962	Motion by petr. for extension of time to February 25, 1963 to file Brief and to March 27, 1963 to file Reply Brief.

Date	Filings and Proceedings
Jan. 8, 1963	Motion by resp. to Amend Amendment to Answer filed.
	Amendment to Amendment to Answer lodged.
Jan. 14, 1963	Amendment to Amendment to Answer filed
[fol. 3]	
Feb. 12, 1963	Reply to Amendment to Amendment to Answer filed.
Feb. 12, 1963	Brief for Petrs filed
Feb. 25, 1963	Motion by resp. for extension of time from Feb. 25, 1963 to March 11, 1963 to file Brief.
March 11, 1963	Brief for Respondent filed
Apr. 19, 1963	Motion by petr. for enlargement of time to May 15, 1963 to file Reply Brief.
May 13, 1963	Reply Brief for Petr. filed
May 15, 1963	Reply Brief for Resp. filed
Aug. 14, 1963	Memorandum Findings of Fact and Opinion filed Judge Scott
	Decision will be entered under Rule 50
Nov. 14, 1963	Agreed Computation filed and Dec.
Nov. 21, 1963	Decision entered, Judge Scott
	Appellate Proceedings
Feb. 17, 1964	Stipulation for Venue filed.
Feb. 17, 1964	Petition for Review by USCA 2nd Cir. filed by petrs.
Feb. 17, 1964	Notice of Filing Petition for Review to Both Parties filed, with proof of service thereon by resp.
Feb. 17, 1964	Notice of Date of Transmission of Record to Both Parties.

[fol. 4]

T. C. Memo. 1963-212

BEFORE THE TAX COURT OF THE UNITED STATES

Docket No. 90189

WALTER F. TELLIER AND EVELYN H. TELLIER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

EXCERPTS FROM MEMORANDUM FINDINGS OF FACT AND OPINION—filed August 14, 1963

Michael Kaminsky, for the petitioners.

Laurence Goldfein, for the respondent.

SCOTT, *Judge*: Respondent determined deficiences in petitioners' income taxes for the years and in the amounts as follows:

Year	Deficiency
1952	$26,965.96
1953	30,955.12
1954	31,938.86
1955	44,741.71
1956	2,227.31

The issues for decision are: (1) whether the gains realized by petitioners on the sale of certain securities constitute ordinary income or capital gains, and (2) whether legal expenses incurred and paid by one of petitioners in

[fol. 5] the unsuccessful defense of a criminal prosecution are deductible.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

Petitioners, husband and wife now residing in Rye, New York, filed a joint Federal income tax return with the district director of internal revenue, Lower Manhattan, New York for the calendar year 1952 and filed joint Federal income tax returns with the district director, Newark, New Jersey, for the calendar years 1953, 1954, 1955 and 1956. On each of these returns the occupation of Walter F. Tellier (hereinafter referred to as petitioner) was shown as "Security dealer."

* * * *

[fol. 6] * * *
[fol. 7]

* * * *

During the period January 1, 1952 to May 11, 1956 petitioner was the controlling and principal participant in the business conducted under the name Tellier and Company. After May 11, 1956 and for the remainder of 1956, petitioner continued the business of Tellier and Company individually under that name. At all times petitioner exercised complete control over the policy and management of Tellier and Company and the other participants performed only those functions assigned to them by petitioner which included the supervision of employees who worked directly under them.

Tellier and Company was registered with the Securities and Exchange Commission as brokers and dealers in securities, and petitioner and Tellier and Company maintained places of business during the years here involved at 1 Exchange Place, Jersey City, New Jersey and at 42 Broadway, New York, New York.

At all times material hereto Tellier and Company acted as an underwriter in the public sale of stock offerings of corporations and purchased corporate securities for resale to customers with the purpose of deriving a profit on

the spread between the purchase and sales prices. Included in the securities purchased by Tellier and Company for resale were securities which had been distributed through its underwriting activities. In many instances Tellier and Company acted as underwriters in the public sale of securities of corporations starting new businesses with capital entirely raised by an initial public sale of capital stock. Tellier and Company also acted as a broker or agent in the sale of securities and the profits it derived from this function were in the form of commissions.

[fols. 8-19] * * *

[fol. 20]

* * * *

Petitioner was tried and convicted upon a thirty-six count indictment charging him with violations of the fraud section of the Securities Act of 1933, 15 U.S.C. section 77(q)(a); with violations of the mail fraud statute, 18 U.S.C. section 341; and with conspiracy to violate each of those statutes, 18 U.S.C. section 371.

Petitioner on April 12, 1957 received concurrent sentences of 4½ years of imprisonment on each count and was fined a total of $18,000 as a result of the criminal conviction referred to above.

In connection with the unsuccessful defense of this criminal prosecution, petitioner in 1956 incurred and paid legal expenses in the amount of $22,964.20 and claimed a deduction for such amount as a business expense. Respondent disallowed the claimed deduction.

[fol. 21]

* * * *

OPINION

* * * *

[fols. 22-28] * * *

[fol. 29]

* * * *

The second issue is whether legal expenses incurred and paid in the unsuccessful defense of a criminal prosecution are deductible. The Courts have long held that such expenses are not deductible and one of the reasons for the

disallowance of such deductions has been that their allowance would frustrate clearly defined public policy. *Burroughs Bldg. Material Co.* v. *Commissioner*, 47 F. 2d 178 (C.A. 2, 1931) affirming 18 B.T.A. 101; *Anthony Cornero Stralla*, 9 T.C. 801 (1947); *Thomas A. Joseph*, 26 T.C. 562 (1956); *Henry L. Peckham*, 40 T.C. —— (May 15, 1963) on appeal (C.A. 4, July 10, 1963). See *Commissioner* v. *Heininger*, 320 U.S. 467 (1943); and Cf. *Tank Truck Rentals* v. *Commissioner*, 356 U.S. 30 (1958).

Petitioner argues that the recent Supreme Court opinion of *Gideon* v. *Wainwright*, 372 U.S. 335 (1963), indicates a public policy of providing legal counsel for defendants in criminal actions and therefore petitioner asserts it should not be inferred that Congress intended to withhold a tax deduction for those employing counsel in defending criminal prosecutions. There is no question that it is in the public interest that defendants have counsel in crimi- [fol. 30] nal prosecutions and that it has been held to be a constitutional right secured by the sixth and fourteenth amendments. The fact that an expenditure is in connection with a constitutionally guaranteed right does not require the conclusions that the amount so expended is deductible as an ordinary and necessary business expense. *Cammarano* v. *United States*, 358 U.S. 498 (1959). Even though the payment of legal fees in the unsuccessful defense of a criminal prosecution may not be as proximately related to the illegal activity as the payment of the fines and penalties involved in the *Tank Truck Rentals* case, such legal expenses flow from the illegal acts.

Petitioner claims *Longhorn Portland Cement Co.*, 3 T.C. 310 (1944) supports his position. In that case we allowed deductions for payments made in compromise of a State antitrust action brought against the taxpayer and for the legal fees relative to the action. However, in *Longhorn Portland Cement Co.*, *supra*, we pointed out that the taxpayer was not proven guilty of the alleged antitrust violations, that the court's judgment in the antitrust action specified that the settlement agreement was not to be construed as an admission of guilt, and further that the taxpayer entered into the settlement rather than assert its innocence for sound business reasons. Petition-

er in the instant case was tried and found guilty of the illegal acts with which he was charged. Cf. *Henry L. Peckham, supra.*

We sustain respondent in his disallowance of petitioner's claimed deduction for legal fees paid in the unsuccessful defense of a criminal prosecution.

Other issues raised by the pleading have been disposed of by agreement of the parties.

Decision will be entered under Rule 50.

[fol. 31]

BEFORE THE TAX COURT OF THE UNITED STATES

Docket No. 90189

WALTER F. TELLIER AND EVELYN H. TELLIER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

DECISION—Entered November 21, 1963

Pursuant to the opinion of the Court filed August 14, 1963, and the agreed computation of the tax liabilities filed by the parties; and incorporating herein the facts recited in the computation as the findings of the Court, it is

ORDERED and DECIDED: That there are deficiencies in income tax due from the petitioners for the taxable years

1952 through 1956 in the respective amounts of $26,965.96, $30,955.12, $33,052.78, $44,741.71, and $2,227.31.

(Signed) IRENE F. SCOTT
Judge

Entered Nov 21 1963

* * * *

It is hereby stipulated that the foregoing decision includes an increased deficiency in income tax in the amount of $1,113.92 for the taxable year 1954, claim for which [fol. 32] the respondent makes pursuant to the provisions of § 6214(a) of the Internal Revenue Code of 1954.

It is further stipulated that the foregoing decision is in accordance with the opinion of the Court and the agreed computation of the parties, and that the Court may enter this decision without prejudice to the right of either party to contest the correctness of the decision entered herein, pursuant to the statute in such cases made and provided.

MICHAEL KAMINSKY
Counsel for Petitioners

(Signed) R. P. Hertzog
FXG

R. P. HERTZOG
ACTING CHIEF COUNSEL
INTERNAL REVENUE SERVICE

[fol. 33]

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 29—September Term, 1964.

Argued October 8, 1964

Docket No. 28823

WALTER F. TELLIER AND EVELYN H. TELLIER,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

OPINION—February 16, 1965

Before:

LUMBARD, *Chief Judge*,
HAYS and ANDERSON, *Circuit Judges*.

Petition for review of a decision of the Tax Court, Scott, *Judge*, T. C. Memo. 1963-212, 22 CCH Tax Ct. Mem. 1062, insofar as that decision found that income from the sale of certain securities was taxable as ordinary income because the securities were held for sale to customers in the ordinary course of business, Section 117 (a) (1) (A) of the Internal Revenue Code of 1939 (Section 1221 (1) of the 1954 Code).

Affirmed as to this issue.

[fols. 34-35] * * *

[fol. 36]

* * * *

HAYS, *Circuit Judge* (with whom Chief Judge Lumbard, Judges Waterman, Friendly, Smith, Kaufman, Marshall and Anderson concur):

II.

The second issue presented in this case is whether legal expenses for the unsuccessful defense of a criminal action are deductible. We have decided that this problem, though [fol. 37] long considered as authoritatively answered in this Circuit, should be reexamined.[3]

Taxpayer was tried and convicted on a thirty-six count indictment charging him with violations of the fraud section of the Securities Act of 1933,[4] with violations of the mail fraud statute,[5] and with conspiracy to violate these statutes.[6] He was sentenced to four and one-half years of imprisonment on each count, the sentences to run concurrently, and was fined $18,000. He claimed a deduction in 1956 in the amount of $22,964.20, representing expenditures during that year incurred in his defense in the criminal proceeding. The Commissioner disallowed this deduction and his ruling was sustained by the Tax Court.

In disallowing a deduction for the expenses of an unsuccessful defense of a criminal action the tax authorities are following a purely judge-made rule. There is nothing in the statute which dictates or even suggests such a result. The applicable provision is Section 162 of the 1954 Code which provides:

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[3] After the appeal on this issue was heard by a panel consisting of Chief Judge Lumbard and Circuit Judges Hays and Anderson, the qualified judges of this Court agreed that the appeal should be considered *en banc*.

The appeal brought into question a principle which heretofore had been well settled by a prior decision of this Court. It was felt that we should reverse a previous categorical ruling of the Court only by vote of all the qualified circuit judges considering the question *en banc*.

[4] § 17, 48 Stat. 84 (1933), as amended, 15 U. S. C. § 77q(a) (1958).

[5] 18 U. S. C. § 1341 (1958).

[6] 18 U. S. C. § 371 (1958).

> "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . ."

There is no provision which expressly prohibits the deduction of the expenses of an unsuccessful defense. The general prohibition on deductions, Section 262, reads:

[fol.38] "Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses."

That the framers of the legislation did not intend that it should be used for moral reform is indicated by the following bit of legislative history: In the Senate debate over the provision with respect to business losses, objection was raised to its liberality. It was suggested that deductions for losses be permitted only when incurred in a "legitimate" trade or business. The suggestion was rejected. Senator Williams, who was in charge of the income tax sections of the bill, explained that the object of the bill was

> "to tax a man's net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures or losses. It is not to reform men's moral characters, that is not the object of the bill at all. The tax is not levied for the purposes of restraining people from betting on horse races or upon 'futures,' but the tax is framed for the purpose of making a man pay upon his net income, his actual profit during the year." 50 Cong. Rec. 3849 (1913).

In 1951 Congress rejected a proposal for disallowing deductions under Section 162 "for any expense paid or incurred in or as a result of illegal wagering" on the ground that the Internal Revenue Code was not intended to penalize or prohibit unlawful activities.[7]

Randolph Paul said:

> "As exploration of relevant Congressional debates indicates, Section 23(a)(1)(A) [Section 162(a)] is

[7] 97 Cong. Rec. 12230-44 (1951).

not an essay in morality, designed to encourage vir-
[fol. 39] tue and discourage sin. It 'was not contrived as an arm of the law to enforce State criminal statutes by augmenting the punishment which the State inflicts.' Nor was it contrived to implement the various regulatory statutes which Congress has from time to time enacted. The provision is more modestly concerned with 'commercial net income'—a businessman's net accretion in wealth during the taxable year after due allowance for the operating costs of the business. . . . There is no evidence in the Section of an attempt to punish taxpayers . . . when the Commissioner feels that a state or federal statute has been flouted. The statute hardly operates 'in a vacuum,' if it serves its own vital function and leaves other problems to other statutes. When Congress has wished to deny tax deductions as a means of reinforcing the sanctions of other federal statutes, it has done so deliberately and explicitly." [8]

No Supreme Court case lends any support to the rule that the legal expenses of an unsuccessful criminal defense when paid or incurred in connection with the carrying on of a trade or business are not deductible. In fact the Court has cast doubt on the rule by what it has said with respect to the reasons ordinarily given to justify the existence of the rule. These reasons are: first, that the expenses occasioned by unlawful activities are not ordinary and necessary in the conduct of a business [9] and sec-
[fol. 40] ond that the allowance of a deduction for such expenses would be contrary to public policy.[10]

Of the legal expenses of resisting issuance by the Postmaster General of a fraud order, the Court said in *Com-*

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[8] *The Use of Public Policy by the Commissioner in Disallowing Deductions,* Proceedings Tax Inst. Univ. of So. Calif. School of Law 715, 730-31 (1954), quoting Member Sternhagen, dissenting in *Burroughs Bldg. Material Co.*, 18 B. T. A. 101, 105 (1929), aff'd, 47 F. 2d 178 (2d Cir. 1931). (Footnotes omitted.)

[9] See, e.g., *National Outdoor Advertising Bureau* v. *Helvering*, 89 F. 2d 878, 880-81 (2d Cir. 1937).

[10] See, e.g., *Burroughs Bldg. Material Co.* v. *Commissioner*, 47 F. 2d 178 (2d Cir. 1931).

missioner v. *Heininger*, 320 U. S. 467, 470, 471, 472 (1943):

> "There can be no doubt that the legal expenses of respondent were directly connected with 'carrying on' his business. . . .
>
> "It is plain that respondent's legal expenses were both 'ordinary and necessary" if those words be given their commonly accepted meaning. For respondent to employ a lawyer to defend his business from threatened destruction was 'normal'; it was the response ordinarily to be expected. Cf. *Deputy* v. *du Pont*, 308 U.S. 488, 495 [1940]; *Welch* v. *Helvering*, 290 U.S. 111, 114 [1933]; *Kornhauser* v. *United States*, [276 U. S. 145 (1928)] . . . Since the record contains no suggestion that the defense was in bad faith or that the attorney's fees were unreasonable, the expenses incurred in defending the business can also be assumed appropriate and helpful, and therefore 'necessary.' . . .
>
> "To say that . . . the expenses . . . were extraordinary or unnecessary would be to ignore the ways of conduct and the forms of speech prevailing in the business world."

To the extent that the equation of illegality with extraordinary and unnecessary is not question begging, it is applying special meanings to "ordinary and necessary" which are not applied in other connections. So long as the expense arises out of the conduct of the business and is a required outlay it ought to be considered ordinary and necessary.

[fol. 41] As to public policy the Supreme Court held in *Lilly* v. *Commissioner*, 343 U. S. 90, 96-97 (1952).

> "Assuming for the sake of argument that, under some circumstances, business expenditures which are ordinary and necessary in the generally accepted meanings of those words may not be deductible as 'ordinary and necessary' expenses under § 23(a)(1)(A) [Section 162(a)] when they 'frustrate sharply defined national or state policies proscribing particular types of conduct,' . . . nevertheless the expendi-

tures now before us do not fall in that class. The policies frustrated must be national or state policies evidenced by some governmental declaration of them." [11]

There has been no "governmental declaration" of any "sharply defined" national or state policy or discouraging the hiring of counsel and the incurring of other legal expense in defense against a criminal charge. In fact it is highly doubtful whether such a public policy could exist in the face of the Sixth Amendment's guaranty of the right to counsel.[12]

[fol. 42] The rule of disallowance of legal expenses in the case of unsuccessful defenses has been adversely criticized by numerous commentators.[13]

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[11] Quoting *Commissioner* v. *Heininger*, 320 U.S. at 473. See also *Tank Truck Rentals, Inc.* v. *Commissioner*, 356 U. S. 30 (1958); *Commissioner* v. *Sullivan*, 356 U. S. 27 (1958).

[12] See *Powell* v. *Alabama*, 287 U. S. 45, 68-69 (1932):

"The right to be hear would be, in many cases, of little avail if it did not comprehend the right to be heard by counsel. Even the intelligent and educated layman has small and sometimes no skill in the science of law. If charged with crime, he is incapable, generally, of determining for himself whether the indictment is good or bad. He is unfamiliar with the rules of evidence. Left without the aid of counsel he may be put on trial without a proper charge, and convicted upon incompetent evidence, or evidence irrelevant to the issue or otherwise inadmissible. He lacks both the skill and knowledge adequately to prepare his defense, even though he have a perfect one. He requires the guiding hand of counsel at every step in the procedings against him. Without it, though he be not guilty, he faces the danger of conviction because he does not know how to establish his innocence."

[13] See, e.g., Arent, *Inequities in Non-Deductibility of Fines, Penalties, Defense Expense*, 87 J. Accountancy 482, 485-86 (1949); Brookes, *Litigation Expenses and the Income Tax*, 12 Tax L. Rev. 241 (1957); Keesling, *Illegal Transactions and the Income Tax*, 5 U. C. L. A. L. Rev. 26, 33-40 (1958); Paul, *supra* note 7; Reid, *Disallowance of Tax Deductions on Grounds of Public Policy—a Critique*, 17 Fed. B. J. 575 (1957); Stapleton, *The Supreme Court Redefines Public Policy* 41 Taxes 641 (1952); Note, *Public Policy and Federal Income Tax Deductions*, 51 Colum. L. Rev. 752, 756-58 (1951); Note, *Deduction of Business Expenses: Illegality and*

Adherence to the rule has led to anomalous, arbitrary, artificial and conflicting results. The attempt to apply a rule which seeks to distinguish between civil and criminal liability and successful and unsuccessful defenses has caused repeated difficulty in borderline cases. A disbarment proceeding, for example, has been classified as criminal and the legal expenses disallowed.[14] Legal expenses paid in behalf of an employee who was found guilty of violating certain sections of the California administrative code relating to horse-racing and who, as a result, lost his license as a trainer, were held deductible, but the court said that had the employee paid his own expenses they "probably" would not have been deductible by him.[15] A taxpayer was permitted to deduct attorney's fees in connection with settlement of a civil liability for assault,[16] while another taxpayer's legal expenses in defending an action for defrauding the government were disallowed.[17] [fol. 43)] When the taxpayer finally pleaded *nolo contendere*, the legal expenses of an unsuccessful trial and a successful appeal (i.e., successful in securing a new trial) were disallowed.[18] Legal fees expended in an unsuccessful attempt to avoid a prosecution resulting in conviction are not deductible.[19] Where a taxpayer pleaded *nolo contendere* to an indictment for tax evasion and the Tax Court later found that there was no fraud or fraudulent evasion for the years in question, the legal expenses connected with the indictment were held to be non-deduct-

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Public Policy, 54 Harv. L. Rev. 852, 854-57 (1941); Comment, *Business Expenses, Disallowances, and Public Policy*, 72 Yale L. J. 108, 132-36 (1962).

[14] *Estate of G. A. Buder*, T. C. Memo. 1963-73, 22 CCH Tax Ct. Mem. 300, aff'd on other issues, 330 F. 2d 441 (8th Cir. 1964).

[15] *Robert S. Howard*, 32 T. C. 1284, 1296 (1959).

[16] *John W. Clark*, 30 T. C. 1330 (1958).

[17] *David R. Faulk*, 26 T. C. 948 (1956).

[18] *Standard Coat, Apron & Linen Serv.*, 40 T. C. 858 (1963).

[19] *Tracy* v. *United States*, 284 F. 2d 379 (Ct. Cl. 1960). *But see Commissioner* v. *Schwartz*, 232 F. 2d 94 (5th Cir. 1956).

ible.[20] On the other hand, legal expenses in connection with an unsuccessful defense against civil liability for taxes are deductible even where a fraud penalty is assessed.[21] The Commissioner disallows legal expenses in government actions under the antitrust laws but allows deduction of such expenses in private actions.[22]

This is the first occasion that we have had since *Heininger* and *Lilly* to reexamine our rule as to deductibility of legal expenses for an unsuccessful defense connected with the carrying on of a trade or business. We hold, following *Heininger*, that such expenses are ordinary and necessary within the meaning of the statute. We find no sharply defined public policy against the allowance of such deductions, as is required by *Lilly*. We therefore refuse to continue to draw any distinction in deductibility between civil and criminal cases or between successful and unsuccessful defenses. We hold that legal expenses are deductible where they arise out of and are immediately or [fol. 44] proximately connected with, and are required for, the conduct of a trade or business.

Reversed.

MOORE, *Circuit Judge*, took no part in the consideration or decision of this case.

LUMBARD, *Chief Judge*, with whom WATERMAN and KAUFMAN, *Circuit Judges*, join (concurring):

While concurring in Judge Hays' opinion for the court, I wish to add a brief word. In our decision in *Burroughs Bdg. Material Co.* v. *Commissioner*, 47 F. 2d 178, 180 (1931), we disallowed expenses incurred in the unsuccessful defense of criminal charges on the ground that to do so would be contrary to public policy. In my opinion,

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[20] *Bell* v. *Commissioner*, 320 F. 2d 953 (8th Cir. 1963).

[21] *Hopkins* v. *Commissioner*, 271 F. 2d 166 (6th Cir. 1959).

[22] Rev. Rul. 64-224, 1964 Int. Rev. Bull. No. 33, at 13.

there is no present basis for the claim that such disallowance is consistent with public policy; on the contrary, it seems clear to me that public policy now requires us to allow the deduction.

Since *Burroughs* was decided, the federal courts have given fuller meaning to the Sixth Amendment, which guarantees to every defendant the right to be represented by counsel.

In 1938 the Supreme Court held in *Johnson* v. *Zerbst*, 304 U. S. 458, that counsel must be furnished an accused who is financially unable to retain his own counsel to defend him on federal charges. A few months ago Congress at long last realized that the right to counsel has little substance unless counsel is paid for his efforts and reimbursed for necessary expenses. Under the provisions of the Criminal Justice Act, 18 U. S. C. § 3006(a), which became law on August 20, 1964, a defendant who is found to be financially unable to provide counsel and defray de- [fol. 45] fense expenses is now entitled to have such reasonable and necessary expenses paid by the government up to specified maximum amounts.

The assignment and compensation of counsel under the Criminal Justice Act do not depend on whether a defendant successfully asserts his innocence. Indeed, almost all of counsel's labors ordinarily must be done and his expenses must be incurred before guilt or innocence is finally established. The defendant has the right to put the government to its proof, if he so elects. His right to counsel does not depend upon whether in fact he has a defense or whether it was reasonable to contest the charges. Surely it needs no argument to support the proposition that unless a defendant has the benefit of counsel who can give necessary attention to the charges and their defense—and in cases such as Tellier's, this is usually a considerable task for conscientious counsel—he may not be in a position to make an intelligent and knowing decision as to whether or how to conduct a defense. Moreover, whether he stands trial or pleads guilty, he needs counsel who has thoroughly familiarized himself with the case and who can plead for his client in the light of such knowledge. If the compensation of counsel under the Criminal Justice

Act does not depend on the success of the defense, it would seem to follow that the allowance of the deduction should not depend on the outcome in cases where the defendant is able to and does assume the financial burden of defending against criminal charges.

In holding that a financially able defendant may deduct as "ordinary and necessary" expenses the legal fees and expenses incurred in an unsuccessful defense, we are being consistent with a clearly evinced policy that a defendant be represented by counsel regardless of the ultimate success or failure of his defense.

[fol. 46] As there is no provision of the tax laws which requires a contrary result, I agree that we should not impose an additional penalty on financially able defendants by refusing a deduction in such cases. The allowance of the deduction here sought is consonant with public policy and ought to be allowed. I think the teaching of *Johnson* v. *Zerbst*, *supra*, *Gideon* v. *Wainwright*, 372 U. S. 335 (1963), and the Criminal Justice Act requires this result and that we are no longer bound by *Burroughs*.

WATERMAN, *Circuit Judge* (concurring):

I concur in Judge Hays' opinion and I also concur in Chief Judge Lumbard's additional separate concurrence.

KAUFMAN, *Circuit Judge* (concurring):

I concur in the opinions of both Judge Hays and Chief Judge Lumbard.

[fol. 47]

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

* * * *

Present:

HON. J. EDWARD LUMBARD, Chief Judge,
HON. STERRY R. WATERMAN,
HON. HENRY J. FRIENDLY,
HON. J. JOSEPH SMITH,
HON. IRVING R. KAUFMAN,
HON. PAUL R. HAYS,
HON. THURGOOD MARSHALL,
HON. ROBERT P. ANDERSON,
Circuit Judges.

WALTER F. TELLIER AND EVELYN H. TELLIER,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

JUDGMENT—February 16, 1965

Appeals from The Tax Court of the United States.

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed in part and reversed in part in accordance with the opinions of this court.

A. DANIEL FUSARO
Clerk

[fol. 48]

[File Endorsement Omitted]

[fol. 49]

[Clerk's certificate to foregoing
transcript omitted in printing]

[fol. 50]

SUPREME COURT OF THE UNITED STATES

* * * *

ORDER EXTENDING TIME TO FILE PETITION FOR WRIT OF CERTIORARI—May 19, 1965

UPON CONSIDERATION of the application of counsel for petitioner,

IT IS ORDERED that the time for filing a petition for writ of certiorari in the above-entitled case be, and the same is hereby, extended to and including June 16, 1965.

/s/ John M. Harlan
Associate Justice of the
Supreme Court of the United States

Dated this May 19th, 1965

[fol. 51]

SUPREME COURT OF THE UNITED STATES

* * * *

ORDER EXTENDING TIME TO FILE PETITION FOR WRIT OF CERTIORARI—June 17, 1965

UPON CONSIDERATION of the application of counsel for petitioner,

IT IS ORDERED that the time for filing a petition for writ of certiorari in the above-entitled case be, and the same is hereby further extended to and including July 16, 1965.

/s/ John M. Harlan
Associate Justice of the
Supreme Court of the United States

Dated this 17th day of June, 1965

[fol. 52]

SUPREME COURT OF THE UNITED STATES

No. 351, October Term, 1965

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WALTER F. TELLIER, ET UX

ORDER ALLOWING CERTIORARI.—October 11, 1965.

The petition herein for a writ a certiorari to the United States Court of Appeals for the Second Circuit is granted; and the case is placed on the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1965 792004 304

In the Supreme Court of the United States

OCTOBER TERM, 1965

No.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WALTER F. TELLIER AND EVELYN H. TELLIER

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 4a–30a)[1] are not officially reported. The opinion of the court of appeals (Appendix, *infra*, pp. 5–19) is reported at 342 F. 2d 690.

JURISDICTION

The judgment of the court of appeals was entered on February 16, 1965 (Appendix, *infra*, pp. 19–20).

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[1] "R." references are to the petitioner's printed appendix in the court of appeals.

781-101—65——1

By order of Mr. Justice Harlan, the Commissioner's time for filing a petition for writ of certiorari was extended to July 16, 1965. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether legal expenses incurred by the taxpayer in the unsuccessful defense of a business-related criminal prosecution for violations of the fraud section of the Securities Act and the mail fraud statute are deductible as ordinary and necessary business expenses under Section 162(a) of the Internal Revenue Code of 1954.

STATUTE INVOLVED

Internal Revenue Code of 1954:

> SEC. 162. TRADE OR BUSINESS EXPENSES.
>
> (a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *.
>
> (26 U.S.C. 162.)

STATEMENT

Taxpayer Walter F. Tellier[2] was engaged in the business of underwriting the public sale of stock offerings and in purchasing securities for resale to customers. He was tried and convicted on a thirty-six count indictment charging him with violations of the fraud section of the Securities Act of 1933 (48 Stat. 84, as amended, 15 U.S.C. 77(q)(a)), the mail fraud

[2] Evelyn H. Tellier is a party because she and her husband filed a joint return for the taxable year 1956.

statute (18 U.S.C. 1341), and conspiracy to violate these provisions (18 U.S.C. 371). He was sentenced to four and one-half years imprisonment on each count, the sentences to run concurrently, and was fined $18,000. On his 1956 income tax return taxpayer deducted $22,964.20 for legal expenses incurred and paid during that year in defense of the criminal proceeding (Appendix, *infra*, p. 9).

The Commissioner disallowed this deduction and his ruling was sustained by the Tax Court (R. 4a–30a). The court of appeals, *en banc*, reversed (Appendix, *infra*, p. 16).[3]

REASONS FOR GRANTING WRIT

The court of appeals' decision in the instant case is in direct conflict with the heretofore uniform rule that legal expenses incurred in the unsuccessful defense of a criminal prosecution are not deductible. This rule was established by the Board of Tax Appeals at least as early as 1925,[4] and has since been adopted by the Courts of Appeals for the Fourth, Sixth and Eighth Circuits and the Court of Claims.[5] Indeed,

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[3] Taxpayer's petition for a writ of certiorari with respect to a second unrelated issue decided in favor of the Commissioner is pending before this Court. (*Tellier* v. *Commissioner*, No. 139, October Term, 1965.)

[4] *Lindheim* v. *Commissioner*, 2 B.T.A. 229. To the same effect, see *Levinstein* v. *Commissioner*, 19 B.T.A. 99; *Sanitary Earthenware Specialty Co.* v. *Commissioner*, 19 B.T.A. 641; *Estate of John W. Thompson* v. *Commissioner*, 21 B.T.A. 568, appeal dismissed, 62 F. 2d 1082 (C.A. 8); *Stralla* v. *Commissioner*, 9 T.C. 801; *Joseph* v. *Commissioner*, 26 T.C. 562; *Standard Coat, Apron & Linen Service, Inc.* v. *Commissioner*, 40 T.C. 858.

[5] *Acker* v. *Commissioner*, 258 F. 2d 568 (C.A. 6), affirmed on other grounds, 361 U.S. 87; *Hopkins* v. *Commissioner*, 271 F.

the Second Circuit's decision in the instant case overrules that court's long-standing position on the question (Appendix, *infra*, pp. 9, 16).[6]

The unanimity of the prior holdings was noted by this Court in *Commissioner* v. *Heininger*, 320 U.S. 467, 473 n. 8: "A taxpayer who has been prosecuted under a federal or state statute and convicted of a crime has not been permitted a deduction for his attorney's fee."

As is apparent without any elaboration of the merits, the question presented is a recurring one and the conflict among the circuits should be resolved by this Court.

CONCLUSION

For the reasons stated, it is respectfully submitted that this petition for a writ of certiorari should be granted.

ARCHIBALD COX,
Solicitor General.
JOHN B. JONES, JR.,
Acting Assistant Attorney General.
HARRY BAUM,
ROBERT A. BERNSTEIN,
Attorneys.

JULY 1965.

2d 166, 167 (C.A. 6); *Bell* v. *Commissioner*, 320 F. 2d 953 (C.A. 8); *Port* v. *United States*, 163 F. Supp. 645 (Ct. Cl.); *Tracy* v. *United States*, 284 F. 2d 379 (Ct. Cl.); *Peckham* v. *Commissioner*, 327 F. 2d 855, 856 n. 4 (C.A. 4), discussing *MacCrowe's Estate* v. *Commissioner*, 240 F. 2d 841 (C.A. 4).

[6] *Burroughs Bldg. Material Co.* v. *Commissioner*, 47 F. 2d 178 (C.A. 2); *National Outdoor Advertising Bureau* v. *Helvering*, 89 F. 2d 878 (C.A. 2).

APPENDIX

United States Court of Appeals for the Second Circuit

No. 29—September Term, 1964

(Argued October 8, 1964. Decided February 16, 1965)

Docket No. 28823

WALTER F. TELLIER AND EVELYN H. TELLIER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Before LUMBARD, *Chief Judge;* HAYS and ANDERSON, *Circuit Judges*

Petition for review of a decision of the Tax Court, Scott, *Judge,* T. C. Memo. 1963–212, 22 CCH Tax Ct. Mem. 1062, insofar as that decision found that income from the sale of certain securities was taxable as ordinary income because the securities were held for sale to customers in the ordinary course of business, Section 117(a)(1)(A) of the Internal Revenue Code of 1939 (Section 1221(1) of the 1954 Code).

Affirmed as to this issue.

Before LUMBARD, *Chief Judge;* WATERMAN, FRIENDLY, SMITH, KAUFMAN, HAYS, MARSHALL and ANDERSON, *Circuit Judges*

Petition for review of the same decision of the Tax Court insofar as that decision disallowed deductions under Section 162(a) of the Internal Revenue Code of 1954 for attorneys' fees incurred in an unsuccessful criminal defense.

Reversed as to this issue.

MICHAEL KAMINSKY, New York, N.Y. (Whitman, Ransom & Coulson, on the brief), *for Petitioners.*

ROBERT A. BERNSTEIN, Attorney, Department of Justice, Washington, D.C. (Louis F. Oberdorfer, Assistant Attorney General, Lee A. Jackson, Harry Baum, Attorneys, Department of Justice, of counsel), *for Respondent.*

HAYS, *Circuit Judge*:

I

The first issue in this case is whether the profits realized from the sale by the taxpayer (Evelyn H. Tellier is a party only because she and her husband filed a joint return) of certain securities during the years 1952–1956 were taxable as ordinary income rather than as capital gain. The resolution of this issue turns upon whether the securities were held by the taxpayer for sale to customers in the ordinary

course of his business of underwriting and selling securities. If they were so held, then under Section 117(a)(1)(A) of the 1954 Code [1] the profits were taxable as ordinary income.

There is ample evidence to support the Tax Court's finding that the taxpayer held the securities for sale in the ordinary course of business. The taxpayer was engaged through Tellier and Company, in form a partnership but in fact wholly controlled by the taxpayer, in the business of underwriting the public sale

[1] Int. Rev. Code of 1939, § 117:

"CAPITAL GAINS AND LOSSES.

"(a) DEFINITIONS.—As used in this chapter—

(1) CAPITAL ASSETS.—The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

"(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business * * *"

Int. Rev. Code of 1954, § 1221:

"CAPITAL ASSET DEFINED.

"For purposes of this subtitle, the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

"(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business * * *"

of stock offerings and in purchasing securities for resale to customers. In connection with the underwriting agreements the taxpayer himself received stock or stock warrants which he sold, frequently through Tellier and Company.

There were seventy separate transactions of this kind during the years in question and the net gains from these sales were:

1952	$74,755.33
1953	74,089.23
1954	49,184.05
1955	97,864.12
1956	13,277.42

On some occasions as an inducement to make more sales of the publicly issued shares, taxpayer would give Tellier and Company's salesmen a part of his stock warrants. Tellier and Company had at all times free call upon the securities which taxpayer kept in an "investment account." The cashier of Tellier and Company had authority to borrow any security it might need either because of a short sale or because a security was not received.

In the words of the Tax Court:

> "The volume of sales, petitioner's activities with respect to the securities, and the close relationship between petitioner's investment accounts and the dealing activities of Tellier and Company support the conclusion that the securities here involved were being held by petitioners for sale to customers in the ordinary course of their trade or business."[2]

Affirmed.

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[2] T. C. Memo. 1963-212, 22 CCH Tax Ct. Mem. 1062, 1069.

HAYS, *Circuit Judge* (with whom Chief Judge Lumbard, Judges Waterman, Friendly, Smith, Kaufman, Marshall and Anderson concur):

II

The second issue presented in this case is whether legal expenses for the unsuccessful defense of a criminal action are deductible. We have decided that this problem, though long considered as authoritatively answered in this Circuit, should be reexamined.[3]

Taxpayer was tried and convicted on a thirty-six count indictment charging him with violations of the fraud section of the Securities Act of 1933,[4] with violations of the mail fraud statute,[5] and with conspiracy to violate these statutes.[6] He was sentenced to four and one-half years of imprisonment on each count, the sentences to run concurrently, and was fined $18,000. He claimed a deduction in 1956 in the amount of $22,964.20, representing expenditures during that year incurred in his defense in the criminal proceeding. The Commissioner disallowed this deduction and his ruling was sustained by the Tax Court.

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[3] After the appeal on this issue was heard by a panel consisting of Chief Judge Lumbard and Circuit Judges Hays and Anderson, the qualified judges of this Court agreed that the appeal should be considered *en banc*.

The appeal brought into question a principle which heretofore had been well settled by a prior decision of this Court. It was felt that we should reverse a previous categorical ruling of the Court only by vote of all the qualified circuit judges considering the question *en banc*.

[4] § 17, 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77q(a) (1958).

[5] 18 U.S.C. § 1341 (1958).

[6] 18 U.S.C. § 371 (1958).

In disallowing a deduction for the expenses of an unsuccessful defense of a criminal action the tax authorities are following a purely judge-made rule. There is nothing in the statute which dictates or even suggests such a result. The applicable provision is Section 162 of the 1954 Code which provides:

> "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *"

There is no provision which expressly prohibits the deduction of the expenses of an unsuccessful defense. The general prohibition on deductions, Section 262, reads:

> "Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses."

That the framers of the legislation did not intend that it should be used for moral reform is indicated by the following bit of legislative history: In the Senate debate over the provision with respect to business losses, objection was raised to its liberality. It was suggested that deductions for losses be permitted only when incurred in a "legitimate" trade or business. The suggestion was rejected. Senator Williams, who was in charge of the income tax sections of the bill, explained that the object of the bill was

> "to tax a man's net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures or losses. It is not to reform men's moral characters, that is not the object of the bill at all. The tax is not levied for the purpose of restraining people from betting on horse races or upon 'futures,' but the tax is framed for the purpose of making a man pay upon his net income, his actual

profit during the year." 50 Cong. Rec. 3849 (1913).

In 1951 Congress rejected a proposal for disallowing deductions under Section 162 "for any expense paid or incurred in or as a result of illegal wagering" on the ground that the Internal Revenue Code was not intended to penalize or prohibit unlawful activities.[7]

Randolph Paul said:

> "As exploration of relevant Congressional debates indicates, Section 23(a)(1)(A) [Section 162(a)] is not an essay in morality, designed to encourage virtue and discourage sin. It 'was not contrived as an arm of the law to enforce State criminal statutes by augmenting the punishment which the State inflicts.' Nor was it contrived to implement the various regulatory statutes which Congress has from time to time enacted. The provision is more modestly concerned with 'commercial net income'—a businessman's net accretion in wealth during the taxable year after due allowance for the operating costs of the business * * *. There is no evidence in the Section of an attempt to punish taxpayers * * * when the Commissioner feels that a state or federal statute has been flouted. The statute hardly operates 'in a vacuum,' if it serves its own vital function and leaves other problems to other statutes. When Congress has wished to deny tax deduction as a means of reinforcing the sanctions of other federal statutes, it has done so deliberately and explicitly."[8]

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[7] 97 Cong. Rec. 12230–44 (1951).

[8] *The Use of Public Policy by the Commissioner in Disallowing Deductions*, Proceedings Tax Inst. Univ. of So. Calif. School of Law 715, 730–31 (1954), quoting Member Sternhagen, dissenting in *Burroughs Bldg. Material Co.*, 18 B.T.A. 101, 105 (1929), aff'd, 47 F. 2d 178 (2d Cir. 1931). (Footnotes omitted.)

No Supreme Court case lends any support to the rule that the legal expenses of an unsuccessful criminal defense when paid or incurred in connection with the carrying on of a trade or business are not deductible. In fact the Court has cast doubt on the rule by what it has said with respect to the reasons ordinarily given to justify the existence of the rule. These reasons are: first, that the expenses occasioned by unlawful activities are not ordinary and necessary in the conduct of a business[9] and second that the allowance of a deduction for such expenses would be contrary to public policy.[10]

Of the legal expenses of resisting issuance by the Postmaster General of a fraud order, the Court said in *Commissioner* v. *Heininger,* 320 U.S. 467, 470, 471, 472 (1943):

> "There can be no doubt that the legal expenses of respondent were directly connected with 'carrying on' his business. * * *
>
> "It is plain that respondent's legal expenses were both 'ordinary and necessary' if those words be given their commonly accepted meaning. For respondent to employ a lawyer to defend his business from threatened destruction was 'normal'; it was the response ordinarily to be expected. Cf. *Deputy* v. *du Pont,* 308 U.S. 488, 495 [1940]; *Welch* v. *Helvering,* 290 U.S. 111, 114 [1933]; *Kornhauser* v. *United States,* [276 U.S. 145 (1928)] * * * Since the record contains no suggestion that the defense was in bad faith or that the attorney's fees were unreasonable, the expenses incurred in defending

[9] See, e.g., *National Outdoor Advertising Bureau* v. *Helvering,* 89 F. 2d 878, 880–81 (2d Cir. 1937).

[10] See, e.g., *Burroughs Bldg. Material Co.* v. *Commissioner,* 47 F. 2d 178 (2d Cir. 1931).

> the business can also be assumed appropriate and helpful, and therefore 'necessary.' * * *
>
> "To say that * * * the expenses * * * were extraordinary or unnecessary would be to ignore the ways of conduct and the forms of speech prevailing in the business world."

To the extent that the equation of illegality with extraordinary and unnecessary is not question begging, it is applying special meanings to "ordinary and necessary" which are not applied in other connections. So long as the expense arises out of the conduct of the business and is a required outlay it ought to be considered ordinary and necessary.

As to public policy the Supreme Court held in *Lilly* v. *Commissioner*, 343 U.S. 90, 96–97 (1952):

> "Assuming for the sake of argument that, under some circumstances, business expenditures which are ordinary and necessary in the generally accepted meanings of those words may not be deductible as 'ordinary and necessary' expenses under § 23(a)(1)(A) [Section 162(a)] when they 'frustrate sharply defined national or state policies proscribing particular types of conduct,' * * * nevertheless the expenditures now before us do not fall in that class. The policies frustrated must be national or state policies evidenced by some governmental declaration of them." [11]

There has been no "governmental declaration" of any "sharply defined" national or state policy or discouraging the hiring of counsel and the incurring of other legal expense in defense against a criminal charge. In fact it is highly doubtful whether such a

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[11] Quoting *Commissioner* v. *Heininger*, 320 U.S. at 473. See also *Tank Truck Rentals, Inc.* v. *Commissioner*, 356 U.S. 30 (1958); *Commissioner* v. *Sullivan*, 356 U.S. 27 (1958).

public policy could exist in the face of the Sixth Amendment's guaranty of the right to counsel.[12]

The rule of disallowance of legal expenses in the case of unsuccessful defenses has been adversely criticized by numerous commentators.[13]

Adherence to the rule has led to anomalous, arbitrary, artificial and conflicting results. The attempt to apply a rule which seeks to distinguish between

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[12] See *Powell* v. *Alabama*, 287 U.S. 45, 68–69 (1932):

"The right to be heard would be, in many cases, of little avail if it did not comprehend the right to be heard by counsel. Even the intelligent and educated layman has small and sometimes no skill in the science of law. If charged with crime, he is incapable, generally, of determining for himself whether the indictment is good or bad. He is unfamiliar with the rules of evidence. Left without the aid of counsel he may be put on trial without a proper charge, and convicted upon incompetent evidence, or evidence irrelevant to the issue or otherwise inadmissible. He lacks both the skill and knowledge adequately to prepare his defense, even though he have a perfect one. He requires the guiding hand of counsel at every step in the proceedings against him. Without it, though he be not guilty, he faces the danger of conviction because he does not know how to establish his innocence."

[13] See, e.g., Arent, *Inequities in Non-Deductibility of Fines, Penalties, Defense Expense*, 87 J. Accountancy 482, 485–86 (1949); Brookes, *Litigation Expenses and the Income Tax*, 12 Tax L. Rev. 241 (1957); Keesling, *Illegal Transactions and the Income Tax*, 5 U.C.L.A. L. Rev. 26, 33–40 (1958); Paul, *supra* note 7; Reid, *Disallowance of Tax Deductions on Grounds of Public Policy—a Critique*, 17 Fed. B. J. 575 (1957); Stapleton, *The Supreme Court Redefines Public Policy*, 41 Taxes 641 (1952); Note, *Public Policy and Federal Income Tax Deductions*, 51 Colum. L. Rev. 752, 756–58 (1951); Note, *Deduction of Business Expenses: Illegality and Public Policy*, 54 Harv. L. Rev. 852, 854–57 (1941); Comment, *Business Expenses, Disallowances, and Public Policy*, 72 Yale L. J. 108, 132–36 (1962).

civil and criminal liability and successful and unsuccessful defenses has caused repeated difficulty in borderline cases. A disbarment proceeding, for example, has been classified as criminal and the legal expenses disallowed.[14] Legal expenses paid in behalf of an employee who was found guilty of violating certain sections of the California administrative code relating to horse-racing and who, as a result, lost his license as a trainer, were held deductible, but the court said that had the employee paid his own expenses they "probably" would not have been deductible by him.[15] A taxpayer was permitted to deduct attorney's fees in connection with settlement of a civil liability for assault,[16] while another taxpayer's legal expenses in defending an action for defrauding the government were disallowed.[17] When the taxpayer finally pleaded *nolo contendere,* the legal expenses of an unsuccessful trial and a successful appeal (i.e., successful in securing a new trial) were disallowed.[18] Legal fees expended in an unsuccessful attempt to avoid a prosecution resulting in conviction are not deductible.[19] Where a taxpayer pleaded *nolo contendere* to an indictment for tax evasion and the Tax Court later found that there was no fraud or fraudulent evasion for the years in question, the legal expenses connected with the indictment were held to be non-de-

[14] *Estate of G. A. Buder*, T. C. Memo. 1963–73, 22 CCH Tax Ct. Mem. 300, aff'd on other issues, 330 F. 2d 441 (8th Cir. 1964).

[15] *Robert S. Howard*, 32 T. C. 1284, 1296 (1959).

[16] *John W. Clark*, 30 T. C. 1330 (1958).

[17] *David R. Faulk*, 26 T. C. 948 (1956).

[18] *Standard Coat, Apron & Linen Serv.*, 40 T. C. 858 (1963).

[19] *Tracy* v. *United States*, 284 F. 2d 379 (Ct. Cl. 1960). *But see Commissioner* v. *Schwartz*, 232 F. 2d 94 (5th Cir. 1956).

ductible.[20] On the other hand, legal expenses in connection with an unsuccessful defense against civil liability for taxes are deductible even where a fraud penalty is assessed.[21] The Commissioner disallows legal expenses in government actions under the antitrust laws but allows deduction of such expenses in private actions.[22]

This is the first occasion that we have had since *Heininger* and *Lilly* to reexamine our rule as to deductibility of legal expenses for an unsuccessful defense connected with the carrying on of a trade or business. We hold, following *Heininger,* that such expenses are ordinary and necessary within the meaning of the statute. We find no sharply defined public policy against the allowance of such deductions as is required by *Lilly.* We therefore refuse to continue to draw any distinction in deductibility between civil and criminal cases or between successful and unsuccessful defenses. We hold that legal expenses are deductible where they arise out of and are immediately or proximately connected with, and are required for, the conduct of a trade or business.

Reversed.

MOORE, *Circuit Judge,* took no part in the consideration or decision of this case.

LUMBARD, *Chief Judge,* with whom WATERMAN and KAUFMAN, *Circuit Judges,* join (concurring):

While concurring in Judge Hays' opinion for the court, I wish to add a brief word. In our decision in

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[20] *Bell* v. *Commissioner*, 320 F. 2d 953 (8th Cir. 1963).

[21] *Hopkins* v. *Commissioner*, 271 F. 2d 166 (6th Cir. 1959).

[22] Rev. Rul. 64-224, 1964 Int. Rev. Bul. No. 33, at 13.

Burroughs Bldg. Material Co. v. *Commissioner,* 47 F. 2d 178, 180 (1931), we disallowed expenses incurred in the unsuccessful defense of criminal charges on the ground that to do so would be contrary to public policy. In my opinion, there is no present basis for the claim that such disallowance is consistent with public policy; on the contrary, it seems clear to me that public policy now requires us to allow the deduction.

Since *Burroughs* was decided, the federal courts have given fuller meaning to the Sixth Amendment, which guarantees to every defendant the right to be represented by counsel.

In 1938 the Supreme Court held in *Johnson* v. *Zerbst,* 304 U.S. 458, that counsel must be furnished an accused who is financially unable to retain his own counsel to defend him on federal charges. A few months ago Congress at long last realized that the right to counsel has little substance unless counsel is paid for his efforts and reimbursed for necessary expenses. Under the provisions of the Criminal Justice Act, 18 U.S.C. § 3006(a), which became law on August 20, 1964, a defendant who is found to be financially unable to provide counsel and defray defense expenses is now entitled to have such reasonable and necessary expenses paid by the government up to specified maximum amounts.

The assignment and compensation of counsel under the Criminal Justice Act do not depend on whether a defendant successfully asserts his innocence. Indeed, almost all of counsel's labors ordinarily must be done and his expenses must be incurred before guilt or innocence is finally established. The defendant has the right to put the government to its proof, if he so elects. His right to counsel does not depend

upon whether in fact he has a defense or whether it was reasonable to contest the charges. Surely it needs no argument to support the proposition that unless a defendant has the benefit of counsel who can give necessary attention to the charges and their defense—and in cases such as Tellier's, this is usually a considerable task for conscientious counsel—he may not be in a position to make an intelligent and knowing decision as to whether or how to conduct a defense. Moreover, whether he stands trial or pleads guilty, he needs counsel who has thoroughly familiarized himself with the case and who can plead for his client in the light of such knowledge. If the compensation of counsel under the Criminal Justice Act does not depend on the success of the defense, it would seem to follow that the allowance of the deduction should not depend on the outcome in cases where the defendant is able to and does assume the financial burden of defending against criminal charges.

In holding that a financially able defendant may deduct as "ordinary and necessary" expenses the legal fees and expenses incurred in an unsuccessful defense, we are being consistent with a clearly evinced policy that a defendant be represented by counsel regardless of the ultimate success or failure of his defense.

As there is no provision of the tax laws which requires a contrary result, I agree that we should not impose an additional penalty on financially able defendants by refusing a deduction in such cases. The allowance of the deduction here sought is consonant with public policy and ought to be allowed. I think the teaching of *Johnson* v. *Zerbst, supra, Gideon* v. *Wainwright,* 372 U.S. 335 (1963), and the Criminal

Justice Act requires this result and that we are no longer bound by *Burroughs*.

WATERMAN, *Circuit Judge* (concurring):

I concur in Judge Hays' opinion and I also concur in Chief Judge Lumbard's additional separate concurrence.

KAUFMAN, *Circuit Judge* (concurring):

I concur in the opinions of both Judge Hays and Chief Judge Lumbard.

JUDGMENT

United States Court of Appeals, Second Circuit

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the sixteenth day of February one thousand nine hundred and sixty-five.

Present: Hon. J. Edward Lumbard, *Chief Judge*, Hon. Sterry R. Waterman, Hon. Henry J. Friendly, Hon. J. Joseph Smith, Hon. Irving R. Kaufman, Hon. Paul R. Hays, Hon. Thurgood Marshall, Hon. Robert P. Anderson, *Circuit Judges*.

WALTER F. TELLIER AND EVELYN H. TELLIER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Appeals from the Tax Court of the United States

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said Tax Court of the United States be and hereby is, affirmed in part and reversed in part in accordance with the opinions of this Court.

A. DANIEL FUSARO, *Clerk.*

U.S. GOVERNMENT PRINTING OFFICE: 1968

FILE COPY

IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No. 351

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

—v.—

WALTER F. TELLIER and EVELYN H. TELLIER,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENTS IN OPPOSITION

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BRIEF FOR THE RESPONDENTS IN OPPOSITION

Opinions Below

The unreported memorandum opinion of the Tax Court is reprinted on pages 4a-30a of the printed appendix in the Court of Appeals which was filed in *Tellier* v. *Commissioner,* No. 139, October Term, 1965. The opinion of the Court of Appeals, reprinted in petitioner's Appendix, pages 5-19, is reported at 342 F. 2d 690.

Jurisdiction

The petition correctly states the jurisdictional basis.

Question Presented

When the Commissioner admits that expenditures for a defense against criminal charges are otherwise ordinary and necessary expenses paid in carrying on a trade or business, may he, nevertheless, disallow a deduction for such expenditures for the sole reason that the defense failed?

Statute Involved

The statute involved, Section 162 of the Internal Revenue Code of 1954, is printed on page 2 of the petition.

Statement

Respondent, Walter F. Tellier, was indicted, tried and convicted for violation of 15 U. S. C. 77(q)(a)—the fraud section of the Securities Act of 1933, 18 U. S. C. 1341—the mail fraud statute, and 18 U. S. C. 371—the conspiracy statute, in connection with certain of his acts occurring while he carried on his business as un underwriter for securities offered for sale to the public. During 1956, respondent spent $22,964.20 to defend himself against those charges.

The Commissioner refused to allow any deduction for such defense for the sole reason that respondent had lost the defense. The Tax Court approved the Commissioner's determination, but the Court of Appeals, *en banc,* reversed, refusing to draw a distinction between a successful and an unsuccessful defense against criminal charges, so long as the charges arose out of or were immediately or proximately related to the conduct of a trade or business (Petitioner's Appendix, p. 16).

ARGUMENT

I

The Court of Appeals correctly applied the principle of *Commissioner* v. *Heininger*, 320 U. S. 467 (1943).

Heininger was a licensed dentist, who sold dentures by mail order. He was accused of false and fraudulent mailings. At a departmental hearing, he was deprived of the use of the mails. He fought the order up through the federal courts, but in vain. Thereafter, he deducted the expenses of the litigation on his federal income tax returns. The Commissioner disallowed the deductions.

The only ground on which the Commissioner could support his disallowance was the contention that considerations of public policy dictated the forfeiture of the right to a deduction otherwise clearly allowable as an ordinary and necessary expense of carrying on a trade or business. The Court disagreed. It held that the cost of litigation was not fatally tainted by its remote relation to an act which an administrative agency had determined to be illegal.

In reaching that conclusion, the Court observed that it was not the public policy of the pertinent statutes to deter accused persons from employing counsel for their defense and that a denial of a deduction for the cost of such counsel "would attach a serious punitive consequence" to the administrative finding which Congress has neither expressly nor impliedly indicated should result.

The Tax Court[1] and the Commissioner,[2] however, have advanced the contention that *Heininger* is limited to ad-

[1] *Anthony Cornero Stralla*, 9 T. C. 801, 820-821 (1947).

[2] Rev. Rul. 62-175, 1962-2 C. B. 50.

ministrative findings of unlawful action and has no pertinency to jury verdicts of guilt. The contention produces the anomalous result that a taxpayer may have a deduction for legal fees expended for a defense in a civil proceeding even though he loses, but he forfeits his right to the deduction if the government should successfully proceed criminally on the basis of the very same acts.

That artificial distinction, created by the Tax Court and adopted by the Commissioner, rests solely on the existence of a footnote in the *Heininger* opinion[3] in which this Court had noted that the Second Circuit in *Burroughs Building Material Co.* v. *Commissioner,* 47 F. 2d 178 (2nd Cir. 1931), had previously approved of the disallowance of attorney fees when the taxpayer's defense had failed. The Tax Court contends that the Court had quoted *Burroughs* with approval.

Consequently, the petition for review confronted the Second Circuit with the direct question whether or not *Burroughs* had been overruled by *Heininger.* This is the first time that that narrow issue had arisen in the Second Circuit. For that matter, it is the first time in any Circuit that the facts squarely support a narrow issue of conflict with *Heininger* (p. 6, *infra*).

The Second Circuit could not find any rational basis for a distinction based on the success or failure of a defense or on the identity of the tribunal in which the defense had faltered. It could not find such basis in any decision of this Court and it could not find it in any declaration of public policy. The Second Circuit, therefore, elected to follow *Heininger.*

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[3] *Commissioner* v. *Heininger,* 320 U. S. 467, 473 fn. 8 (1943).

The decision of the Court of Appeals does indeed follow *Heininger;* for just as in *Heininger,* the statutes under which respondent was convicted do not have it for "their policy to deter persons accused of violating their terms from employing counsel to assist in preparing a bona fide defense . . . " and "the deni[al] of the deduction [for the cost of counsel] would attach a serious punitive consequence to the [conviction] which Congress has not expressly or impliedly indicated should result from such [conviction]."

Moreover, as the Chief Judge observed by concurring opinion, the claim that public policy can be said to be hostile to the employment of counsel for a defense is singularly inappropriate today in the circumstances of our present attitudes. Even if *Heininger* were not the law, the reasoning of *Burroughs* could not stand today in the face of those attitudes. As the Chief Judge said,

> . . . the allowance of the deduction here sought is consonant with public policy and ought to be allowed. I think the teaching of *Johnson* v. *Zerbst, supra, Gideon* v. *Wainwright,* 372 U. S. 335 (1963), and the Criminal Justice Act requires this result and that we are no longer bound by *Burroughs.*

It is inconceivable that the Commissioner should contend for a gloss that a taxpayer loses his right to a deduction for his legal costs when he struggles for life or liberty, solely because he has lost, but that he may have the deduction, even though he loses, when he fights for only property. Nevertheless, such is the actual intent of Rev. Ruling 62-175 (*supra*), and such is the only result that can follow from the success of the petition here.

II

There is no conflict with any authority.

The public policy contention is a last-ditch barricade against a deduction. Its assistance is needed only when the Commissioner cannot find a statutory basis for disallowance; that is, when he cannot deny that the expense naturally followed from the operation of the taxpayer's trade or business, or that it was ordinary and necessary in the carrying on of such trade or business. On the other hand, if there is no statutory basis for the deduction of attorney fees, the issue of public policy is irrelevant. *Richard F. Smith,* 31 T. C. 1, 10 (1958), Acq. 1959-1 C. B. 5.

There is a crucial distinction between this controversy and every decision which the Solicitor General has cited as in conflict with the Second Circuit's decision. This controversy is unique in the fact that it is the only one in which the taxpayer has fully passed the test of connection between his expenditures for assistance by counsel and the normal carrying on of his trade or business. This controversy, therefore, is the only one that is completely on all fours with *Heininger,* presenting no question whatsoever but that except for the public policy issue, the expenditures are completely allowable.

As the Court of Claims said in *Port* v. *United States,* 163 F. Supp. 645, 647 (Ct. Cl. 1958):

> The concession which the United States made in *Heininger* is precisely the concession that it refuses to make here, that is, that the present plaintiff's legal expenses proximately resulted from, and were directly

related to his "business" or the "management, conservation, or maintenance of property held for the production of income." Nor do we believe that such a finding by us would be justified.

Both the *Port* case and *Tracy* v. *United States,* 284 F. 2d 379 (Ct. Cl. 1960), which followed, involved attorney fees in defense of charges of filing false and fraudulent personal income tax returns. In the latter case, the Court of Claims specifically refused to base its decision on considerations of public policy. It reaffirmed its reasoning in *Port,* disallowing the deduction only for the lack of relation to the carrying on of a business.

Since the Court of Claims applies the same test of proximate connection, its decisions are in agreement with that by the Second Circuit.

The two Sixth Circuit cases, *Acker* v. *Commissioner,* 258 F. 2d 568 (6th Cir. 1958) and *Hopkins* v. *Commissioner,* 271 F. 2d 166 (6th Cir. 1959), were also cases involving unsuccessful defenses against criminal income tax charges. In the first, the Sixth Circuit, with a bare two paragraph statement, simply approved a decision of the Tax Court (T. C. Memo. 1957-18 (1957), CCH 16 T. C. M. 89) that had ruled that the effect of a prosecution for falsely filing a personal tax return on the taxpayer's business was only incidental; hence, the cost of defense was not a cost of doing business. In the second, the Sixth Circuit referred to its earlier decision as recognizing " . . . the settled rule that legal fees paid by a taxpayer in his defense of an unsuccessful criminal trial for income tax evasion are not deductible" (at 271 F. 2d, pp. 167, 168).

It is therefore not possible to definitely conclude that the Sixth Circuit has developed a clear rule disallowing the cost of an unsuccessful defense against business-connected criminal charges on the basis of public policy. It would seem to be much more correct to say, since its rule was established in a case where the determinative issue was the proximate connection between the taxpayer's business and his filing of fraudulent tax returns, that the Sixth Circuit follows the Court of Claims, and holds that it is not part of a taxpayer's business to file false returns of his income.

Bell v. *Commissioner,* 320 F. 2d 953 (8th Cir. 1963), was another controversy involving prosecution for willful tax evasion. There is absolutely no mention of the public policy issue in the opinion, and the decision is squarely supported by a finding that the expenses were caused by the taxpayer's "personal misconduct" (at 320 F. 2d, p. 958). The Eighth Circuit rested its opinion on proximate cause as did the Second Circuit here.

The two Fourth Circuit opinions, *Estate of MacCrowe* v. *Commissioner,* 240 F. 2d 841 (4th Cir. 1956) and *Peckham* v. *Commissioner,* 327 F. 2d 855 (4th Cir. 1964), are the only non-income tax prosecution cases cited by the Solicitor General. Both involved the prosecution of physicians for criminal abortions.

In the latter (at 327 F. 2d 857), the Court of Appeals said,

> The taxpayer has not sustained the burden of proof that his legal expenses were connected with carrying on his business or profession. . . . In this respect the case differs from *Commissioner* v. *Heininger,* 320 U. S.

467 (1943) where the record did show that the legal expenses were directly connected with carrying on a business.

It is submitted that in no case cited by the Solicitor General was the question of public policy the actual determining factor. On the contrary, the decision in each of the cases really turned on the question of the statutory requirement that the payment be an ordinary and necessary expense of carrying on the taxpayer's business. Since in all opinions, the respective courts insisted on applying the test of proximate cause, which the Second Circuit also applied here, it is evident that all authorities are now in full agreement so far as the applicable principle of law is concerned.

Moreover, no test other than that of proximate cause would be consonant with the Court's decisions which have subsequently clarified the rule in *Heininger*. As the Court said in *Commissioner* v. *Sullivan*, 356 U. S. 27, 29 (1958):

> . . . We said in *Commissioner* v. *Heininger*, 320 U. S. 467, 474, . . . that the "fact that an expenditure bears a remote relation to an illegal act" does not make it nondeductible. . . .
>
> . . . the amounts paid as wages to employees and to the landlord as rent are "ordinary and necessary expenses" in the accepted meaning of the words. That is enough to permit the deduction, unless it is a device to avoid the consequence of violations of a law, as in *Hoover Motor Express Co.* v. *United States, supra*, and *Tank Truck Rentals, Inc.* v. *Commissioner, supra*, or otherwise contravenes the federal policy, expressed in a statute or regulation, as in *Textile Mills Secur. Corp.* v. *Commissioner*. . . .

CONCLUSION

For the foregoing reasons, it is respectfully submitted that this petition for a writ of certiorari should be denied.

Respectfully submitted,

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August , 1965

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In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 351

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WALTER F. TELLIER AND EVELYN H. TELLIER

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Tax Court (R. 4) is not officially reported. The opinion of the court of appeals (R. 10) is reported at 342 F. 2d 690.

JURISDICTION

The judgment of the court of appeals was entered on February 16, 1965 (R. 20). By order of Mr. Justice Harlan, the Commissioner's time for filing a petition for writ of certiorari was extended to July 16, 1965 (R. 22). The petition was filed on July 15, 1965, and certiorari was granted on October 11, 1965

(R. 23). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether legal expenses incurred by respondent in the unsuccessful defense of a federal criminal prosecution for violations of the fraud section of the Securities Act and the mail fraud statute qualify for deduction from taxable income under § 162(a) of the Internal Revenue Code of 1954 as "ordinary and necessary expenses * * * in carrying on any trade or business."

STATUTES INVOLVED

Internal Revenue Code of 1954:

> SEC. 162. TRADE OR BUSINESS EXPENSES.
>
> (a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *.
> (26 U.S.C. 162.)
>
> * * * * *
>
> SEC. 262. PERSONAL, LIVING, AND FAMILY EXPENSES.
>
> Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.
> (26 U.S.C. 262.)

STATEMENT

Respondent[1] was engaged in the business of underwriting the public sale of stock offerings and purchasing securities for resale to customers. He was tried

[1] Evelyn H. Tellier is a party because she and her husband filed a joint return for the taxable year 1956.

and convicted on a thirty-six count indictment charging him with violations of the fraud section of the Securities Act of 1933 (48 Stat. 84, as amended, 15 U.S.C. 77(q)(a)), the mail fraud statute (18 U.S.C. 1341), and conspiracy to violate these provisions (18 U.S.C. 371).[2] He was sentenced to four and one-half years imprisonment on each count, to run concurrently, and to a fine of $18,000. In connection with the unsuccessful defense of this criminal prosecution, respondent, in 1956, incurred and paid $22,964.20 legal expenses. He claimed a deduction for that amount as a business expense on his 1956 income tax return (R. 5–6).

The Commissioner disallowed this deduction and his determination was sustained by the Tax Court (R. 7–9). The court of appeals, sitting *en banc*, unanimously reversed (R. 11–19).[3]

INTRODUCTION AND SUMMARY OF ARGUMENT

The decision below marks an abrupt departure from the accepted view that legal expenses incurred in the unsuccessful defense of a criminal prosecution are not deductible in any circumstances. Until the court of appeals reversed the Tax Court in the instant case, the courts, for some 40 years, had uniformly held that such expenses do not qualify for deduction as "ordinary and necessary expenses * * * in carry-

[2] The conviction was affirmed an appeal. *United States* v. *Tellier*, 255 F. 2d 441 (C.A. 2), certiorari denied, 358 U.S. 821.

[3] Taxpayer's petition for a writ of certiorari with respect to a second unrelated issue decided in favor of the Commissioner (*Tellier* v. *Commissioner*, No. 139, October Term, 1965) was denied on October 11, 1965.

ing on any trade or business." Internal Revenue Code of 1954, § 162. This rule was established by the Board of Tax Appeals at least as early as 1925,[4] and had been endorsed by every court of appeals that had passed upon the question,[5] as well as by the Court of Claims.[6] Indeed, the decision of the Second Circuit in the instant case overrules that court's own long-standing position.[7] This Court recognized the unanimous holdings of the lower courts when, in *Commissioner* v. *Heininger*, 320 U.S. 467, 473 n. 8, it stated that, "A taxpayer who has been prosecuted under a federal or state statute and convicted of a crime has not been permitted a deduction for his attorney's fee." The courts have long agreed that "Such unanimity of views in support of a position representing a reasonable construction of an ambiguous statute will

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[4] *Lindheim* v. *Commissioner*, 2 B.T.A. 229. To the same effect, see *Levinstein* v. *Commissioner*, 19 B.T.A. 99; *Sanitary Earthenware Specialty Co.* v. *Commissioner*, 19 B.T.A. 641; *Estate of John W. Thompson* v. *Commissioner*, 21 B.T.A. 568, appeal dismissed, 62 F. 2d 1082 (C.A. 8); *Stralla* v. *Commissioner*, 9 T.C. 801; *Joseph* v. *Commissioner*, 26 T.C. 562; *Standard Coat, Apron & Linen Service, Inc.* v. *Commissioner*, 40 T.C. 858.

[5] *Acker* v. *Commissioner*, 258 F. 2d 568 (C.A. 6), affirmed on other grounds, 361 U.S. 87; *Hopkins* v. *Commissioner*, 271 F. 2d 166, 167 (C.A. 6); *Bell* v. *Commissioner*, 320 F. 2d 953 (C.A. 8); *Peckham* v. *Commissioner*, 327 F. 2d 855, 856 n. 4 (C.A. 4), discussing *MacCrowe's Estate* v. *Commissioner*, 240 F. 2d 841 (C.A. 4).

[6] *Port* v. *United States*, 163 F. Supp. 645 (Ct. Cl.); *Tracy* v. *United States*, 284 F. 2d 379 (Ct. Cl.).

[7] *Burroughs Bldg. Material Co.* v. *Commissioner*, 47 F. 2d 178 (C.A. 2); *National Outdoor Advertising Bureau* v. *Helvering*, 89 F. 2d 878 (C.A. 2).

not lightly be put aside." *United States* v. *Davis*, 370 U.S. 65, 71. Moreover, the "ordinary and necessary" business expense provision has been reenacted without substantial change in every Revenue Act since it first appeared in 1918,[8] and Congress presumably has been aware of the construction consistently placed upon it by the Commissioner and the courts.[9]

While the government, over the years, has urged several grounds supporting disallowance of a deduction for attorney's fees incurred in unsuccessfully defending a criminal prosecution, principal reliance has been placed on the argument that overriding public policy requires the disallowance of such expenses. Point I(A) of this brief sets forth the Commissioner's argument on the application of the public policy doctrine to respondent's attorney's fees. The Acting Solicitor General has doubts, however, that this doctrine should be applied to payments other than those which are themselves illegal or which are intended as punishment for illegal acts. We therefore present the countervailing arguments for the Court's consideration in Point I(B).

The government has also argued in cases similar to this one that, considerations of public policy aside, expenses such as respondent's should be non-deductible

[8] Section 214(a), Revenue Act of 1918, c. 18, 40 Stat. 1057, 1066. See, *infra*, p. 25, for the pre-1918 history of the business deduction provision.

[9] See, *e.g.*, S. Rep. No. 1983, 85th Cong., 2d Sess., pp. 16, 124–125, accompanying Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606, Section 5, which added Section 162(c) of the 1954 Code.

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because they fail to qualify as "ordinary and necessary" in the generally accepted sense and are primarily personal in nature. The Commissioner does not press these other grounds for reversal. However, since these issues are within the framework of the present case, bear a close relation to the public policy argument, have been relied upon by lower courts as additional reasons for disallowing attorney's fees incurred in unsuccessfully defending a criminal prosecution, and derive, at least in part, from statements by this Court, we have set forth in Point II of this brief the competing considerations which bear upon their resolution.

ARGUMENT

I

THE COMMISSIONER URGES THAT OVERRIDING PUBLIC POLICY REQUIRES THE DISALLOWANCE OF LEGAL EXPENSES INCURRED IN THE UNSUCCESSFUL DEFENSE OF A CRIMINAL PROSECUTION

A. THE COMMISSIONER'S POSITION

The Internal Revenue Code nowhere directs that considerations of public policy shall be taken into account in determining the deductibility of expenses which otherwise qualify. Viewed as an original matter, therefore, it might be argued that since the Code is not drawn with an eye to considerations of policy and morality, the courts should leave those matters to regulation by other means. The lower courts, however, have long since decided that in some contexts they should give heed to weighty considerations of policy. And this Court has made clear in recent years

that in at least some circumstances "business expenditures which are ordinary and necessary in the generally accepted meanings of those words may not be deductible" (*Lilly* v. *Commissioner,* 343 U.S. 90, 96) because their allowance would frustrate sharply defined public policy. *Tank Truck Rentals, Inc.* v. *Commissioner,* 356 U.S. 30; *Hoover Motor Express* v. *United States,* 356 U.S. 38 (both disallowing deductions for fines paid to the State). "We will not presume that the Congress, in allowing deductions for income tax purposes, intended to encourage a business enterprise to violate the declared policy of a State [or the federal government]." *Tank Truck, supra,* p. 35.

On the other hand, the Court appears to have rejected a broad rule that would disallow any expenditure that flows directly from or is caused by an illegal act. In light of the high prevailing tax rates such a rule would certainly discourage the commission of the proscribed acts. However, the Court has recognized that a more flexible rule was needed in order "to accommodate both the congressional intent to tax only net income, and the presumption against Congressional intent to encourage violation of declared public policy." *Ibid.* Thus, in *Commissioner* v. *Heininger,* 320 U.S. 467, the Court allowed a deduction for attorney's fees incurred by the taxpayer in unsuccessfully defending against an administrative fraud order issued by the postal authorities, although it recognized that the taxpayer's acts might well constitute a federal criminal offense (p. 474). And in

Commissioner v. *Sullivan*, 356 U.S. 27, the Court held that the "normal" expenses of an illegal business, such as rent and salaries, which are tainted only because the entire business is illegal, may be deducted even if their payment is specifically proscribed by State law, since the Court will not presume that Congress intended such a business to be "taxable on the basis of its gross receipts, while other business would be taxable on the basis of net income" (p. 29).

The Court has thus adopted an approach designed to accommodate conflicting considerations—denying a deduction only for those expenses the allowance of which would most seriously frustrate public policy. "The test of non-deductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction." A deduction will be allowed, however, if the "expenditure bears [only] a remote relation to the illegal act." *Tank Truck*, p. 35. In deciding the present case, the Court must accordingly determine on which side of the line respondent's attorney's fees fall.

In the instant case the Second Circuit adopted a novel approach to the public policy issue—one which is demonstrably at variance with the teaching of this Court. This Court has made it clear that in determining the deductibility of expenses incurred in defending a lawsuit, the expenses must be viewed in light of "the origin and character of the claim" (*United States* v. *Gilmore*, 372 U.S. 39, 49) and that "the kind of transaction out of which the obligation arose" determines its character for tax purposes

(*Deputy* v. *duPont*, 308 U.S. 488, 496). See also, *e.g.*, *Kornhauser* v. *United States*, 276 U.S. 145; *United States* v. *Patrick*, 372 U.S. 53; *Lykes* v. *United States*, 343 U.S. 118. Since respondent's legal fees are the direct and predictable result of his violations of three federal criminal statutes, their deductibility must be considered in light of the public policy embodied in those statutes—the fraud section of the Securities Act of 1933, the mail fraud statute, and the federal conspiracy statute.

The Second Circuit, however, failed to consider the policies expressed by these statutes. Instead, it addressed itself to the question whether "There has been [any] 'governmental declaration' of any 'sharply defined' national or state policy [of] discouraging the hiring of counsel and the incurring of other legal expense in defense against a criminal charge" (R. 15). After reaching the inevitable result that there was certainly no such policy, that court ended its search before it had actually begun, concluding that there was "no sharply defined public policy against the allowance of" respondent's expenses (R. 17).

The Commissioner of course agrees with the Second Circuit's conclusion that respondent had a constitutional right to be represented by counsel in connection with his criminal trial. That court's error, however, was to assimilate the *right to retain counsel* and the *right to deduct counsel fees* for purposes of computing federal income tax liability. Denial of the deduction does not impair the defendant's freedom to select any attorney or to pay him any stipulated fee.

Rather, it might be said that allowance of the deduction would in some measure subsidize the defendant's cost of his legal defense.

It is axiomatic that "only as there is clear provision therefor can any particular deduction be allowed." *New Colonial Co.* v. *Helvering,* 292 U.S. 435, 440. See also *Deputy* v. *du Pont,* 308 U.S. 488, 493. An expense which does not come within one of the authorizing provisions is not deductible simply because it is incurred in connection with the exercise of a constitutional right. Many personal expenses flow from the exercise of constitutionally guaranteed rights, but for purposes of computing income tax liability they are nevertheless clearly non-deductible. As the Tax Court stated, the "fact that an expenditure is in connection with a constitutionally guaranteed right does not require the conclusions that the amount so expended is deductible as an ordinary and necessary business expense" (R. 7).

In *Cammarano* v. *United States,* 358 U.S. 498, the taxpayer deducted as business expenses sums paid for publicity designed to persuade voters to defeat proposed State initiative legislation which would have the effect of destroying his business. In holding that such expenses—although made in the course of exercising a constitutionally guaranteed right—were not deductible under § 162, the Court stated (p. 513):

> Petitioners are not being denied a tax deduction because they engage in constitutionally protected activities, but are simply being required to pay for those activities entirely out of their own pockets, as everyone else en-

> gaging in similar activities is required to do under the provisions of the Internal Revenue Code. * * *

Similarly, the fact that retaining counsel to defend against a criminal charge is a "constitutionally protected" right is not dispositive of the right to deduct such fees. Surely the Second Circuit would agree that the expenses of defending a criminal case arising out of non-profit-seeking activities are non-deductible. The crucial question which remains is whether the expense qualifies for deduction under the Code. The "nondiscriminatory denial of a deduction" for such fees would merely put "everyone in the community * * * on the same footing as regards [the payment of the cost of unsuccessfully defending a criminal prosecution] * * * so far as the Treasury of the United States is concerned" (*Cammarano* v. *United States, supra,* p. 513). Given the progressive nature of the tax rates and the variety of distinctions in defining the tax base and deductions of taxpayers, use of the income tax laws as a vehicle for promoting adequate representation in criminal proceedings would be a singularly inappropriate choice.

This Court's opinion in *Commissioner* v. *Heininger,* 320 U.S. 467, demonstrates the error in the Second Circuit's reasoning. In *Heininger* the taxpayer sought to deduct attorneys fees incurred in unsuccessfully attacking a post office fraud order which threatened his business by denying him use of the mails. The Court held that allowance of the deduction would not frustrate sharply defined national or State policies

since the postal statute in question was designed solely "to protect the public" and not "to impose personal punishment on violators" (p. 474). At the same time, the Court also observed that "A taxpayer who has been prosecuted under a federal or state statute and convicted of a crime has not been permitted a tax deduction for his attorney's fee" (p. 473, fn. 8). Respondent's expenses in the instant case were incurred in unsuccessfully defending a prosecution under three federal statutes designed "to impose personal punishment on violators." Respondent's expenses, therefore, falls squarely within the class that this Court's *Heininger* opinion contemplated would be non-deductible.

Respondent's attorney's fees in connection with his criminal trial are intimately and inextricably connected with the entire legislative and judicial machinery for preventing, combating, and punishing crime. They were directly occasioned by the illegal acts and incurred in the very proceeding in which guilt was determined and punishment imposed. Such expenses are no more remote from the illegal conduct than the fine levied upon conviction, which this Court has already held non-deductible in *Tank Truck Rentals*. In sum, it would stretch this Court's language to classify respondent's criminal trial expenses as bearing merely "a remote relation to an illegal act." *Commissioner* v. *Heininger, supra,* p. 474; *Commissioner* v. *Sullivan,* 356 U.S. at 29. The "severity and immediacy of the frustration resulting from allowance of [respondent's] deduction," *Tank Truck*

Rentals, Inc. v. *Commissioner, supra,* p. 35, is established, first, by the level at which the public policy is expressed, here a penal law;[10] second, by the closeness of the relation between the legal expenses and the criminal conduct; and, third, by the relatively remote and insignificant frustration to the countervailing policy to tax net rather than gross income.[11] As the Court said in *Textile Mills Corp.* v. *Commissioner,* 314 U.S. 327, 339, the Treasury is warranted in "drawing a line between legitimate business expenses and those arising from that family of contracts [or transactions] to which the law has given no sanction." To be sure, the Court in *Textile Mills* and *Cammarano* relied upon a long-standing Treasury Regulation which forbade the deduction of sums expended for the promotion or defeat of legislation. Although there is no Treasury Regulation which proscribes the deduction of legal expenses incurred in the unsuccessful defense of a criminal prosecution, there is a long-standing judicial doctrine to that effect. See cases cited, *supra,* p. 4; *Commissioner* v. *Heininger, supra,* p. 473 n. 8.

The ultimate question, of course, is one of Congressional intent. As shown above, there has been a consistent administrative position over the course of

[10] Contrast *Commissioner* v. *Heininger, supra,* pp. 474–475, and *Lilly* v. *Commissioner, supra.*

[11] Contrast *Commissioner* v. *Sullivan,* 356 U.S. 27. Here the Commissioner does not seek to disallow all of Tellier's expenses related to his illegal conduct, however remotely, such as rent and wages. Disallowance of the single item of legal fees can hardly be said to "come close to making this type of business taxable on the basis of its gross receipts." *Id.* at 29.

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many years and a long line of decisions sustaining the Treasury's view. Since Congress, during this same period, repeatedly reenacted § 162 and since it was presumably aware of the administrative and judicial decision,[11a] there is strong basis for concluding that the Commissioner's position correctly reflects the legislative purpose and that respondent's expenses are not deductible.

B. THE COUNTERVAILING CONSIDERATIONS

The Acting Solicitor General, while agreeing that the recurring legal question here presented should be resolved, has doubts as to the correctness of the Commissioner's position in this case. In all events, it may prove helpful to set forth the opposing arguments and to suggest an alternative line of approach to this and related cases.

As stated above, this Court has chosen neither to ignore considerations of public policy in determining the deductibility of expenses nor to disallow deductions for all expenses flowing out of an illegal act. While the issue is not free from doubt, we believe that the logic of the Court's rationale in choosing the middle rather than either of the extreme positions regarding the effect of public policy on deductions militates in favor of allowing a deduction for respondent's fees if they otherwise satisfy the requirements of § 162. "[T]he test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction." Thus the public policy doctrine will be invoked only when

[11a] See fn. 9, *supra*, p. 5.

allowance of the deduction would "encourage a business enterprise to violate * * * declared policy * * * by increasing the odds in favor of noncompliance." *Tank Truck, supra,* p. 35. Once it has been decided that Congress did not intend the sharp departure from a tax on net income that would result from disallowing all expenses incurred as a result of an illegal act, we believe that disallowance should be limited to those expenditures which are themselves illegal,[12] such as prohibited bribes and kickbacks, and those exactions which are intended as punishment for illegal acts.

The public policy doctrine is, we submit, most clearly applicable to payments intended by the sovereign to punish an offender, whether paid to the government or to private parties. The purpose of a fine or penalty is both to punish the violator and to deter him from again violating the law. Allowing a deduction would reduce the intended "sting" (*Tank Truck,* p. 36) and mitigate the fine's deterrent effect.[13]

It is perhaps not quite as clear that payments which are themselves illegal should be disallowed as deductions. If a taxpayer paid a $10,000 bribe in order to sell merchandise for $50,000 that had cost him $37,500, his actual before-tax profit from the transaction would be $2,500 ($50,000 less $37,500 and $10,000). If, however, the bribe is disallowed for

[12] Other than the "normal" expenses of an illegal business. See *Commissioner* v. *Sullivan,* 356 U.S. 27, 29, and *supra,* p. 8.

[13] This would be untrue only if the court had wide discretion in assessing the amount of fines and did so with due regard for the defendant's tax bracket.

tax purposes and the taxpayer is in the 50% tax bracket, he would be required to pay an income tax of $6,250 (50% of $12,500), *i.e.*, more than double his actual gain from the transaction. Thus the federal tax laws would impose a penalty in proportion to the amount of the illegal expenditure and the taxpayer's income tax bracket, rather than the seriousness of the offense committed. Nevertheless, we believe, on balance, that no deduction should be allowed for illegal expenditures.[14] While it is not the purpose of the tax laws to impose additional penalties for illegal acts, permitting a deduction for those expenditures which are themselves prohibited by federal or State criminal law would cause the federal treasury in effect to subsidize the illegal payment. A taxpayer in the 50% bracket who paid a $10,000 bribe would have his income tax liability reduced by $5,000, and the federal government would thus in effect be subsidizing the illegal payment. Not only might a deduction increase the violator's chances of profiting from illegal conduct; more pointedly, it is difficult to believe that Congress in enacting the Code could have intended the federal treasury in effect to provide a part of the money for an illegal payment.[15] If the choice must be made between adding a penalty to conduct which is

[14] See fn. 12, *supra*, p. 15.

[15] See Code § 162(c), disallowing a deduction for any payment to an official of a foreign government where the payment would have been illegal under the laws of the United States, if they had been applicable. In enacting this provision in 1958 Congress apparently assumed that no deductions would be allowed for a payment actually made in the United States which was itself illegal. See S. Rep. No. 1983, 85th Cong., 2d Sess., pp. 16, 124–125.

already criminal in nature and subsidizing illegal payments, we believe the choice to be clear.[16]

While it would certainly deter illegal conduct if all expenses incurred directly or indirectly as a result of a criminal act were non-deductible, we do not think that Congress can be presumed, absent a clearer demonstration of legislative purpose, to have intended such a sharp departure from the basic concept of a tax on net income measured by business profits. Although attorney's fees and expenses incurred during the unsuccessful defense of a criminal prosecution flow from the illegal act and are as much a consequence of it as the non-deductible penalty assessed after conviction, allowing a deduction for such expenditures would no more encourage criminal conduct than allowing deductions for compensatory civil damages and attendant legal expenses, which are presumably deductible.[17] Indeed, we have the gravest

[16] The Court noted in *Tank Truck* that "the frustration of state [or federal] policy is most complete and direct when the expenditure for which deduction is sought is itself prohibited by statute" (p. 35).

[17] As the Chief Justice stated in *James* v. *United States*, 366 U.S. 213, 219–220 (announcing the judgment of the Court):

> When a law-abiding taxpayer mistakenly receives income in one year, which receipt is assailed and found to be invalid in a subsequent year, the taxpayer must nonetheless report the amount as "gross income" in the year received. * * * We do not believe that Congress intended to treat a law-breaking taxpayer differently. *Just as the honest taxpayer may deduct any amount repaid in the year in which the repayment is made, the Government points out that, "If, when, and to the extent that the victim recovers back the misappropriated funds, there is of course a re-deduction in the embezzler's income."* [Emphasis added.]

The Internal Revenue Service has itself approved deductions for civil remedial damages and attendant attorney's fees, al-

doubt that either type of deduction bears upon the decision of businessmen to engage in violations of law.

The Court's opinion in *Commissioner* v. *Heininger*, 320 U.S. 467, suggests, however, that a distinction might be drawn between the deductibility of attorney's fees in civil and criminal suits. In that case, the Court allowed a deduction for attorney's fees incurred in resisting a postal fraud order, although the taxpayer's conduct may well have been criminal. In so concluding the Court stated that the purpose of the postal statute in question was "to protect the public," not, like a criminal statute, "to impose personal punishment on violators" (p. 474). While the prosecution against the present respondent was clearly intended to punish him, Congress explicitly set forth by statute the possible penalties that could be imposed, and the court, in its discretion, imposed an $18,000 fine and 4½ years imprisonment. Neither Congress nor the courts regarded the attorney's fees which respondent incurred in defending against the charges as a further penalty or punishment for his wrong. The retention of counsel is a basic constitu-

though the expenses were caused by a criminal act. In Rev. Rul. 64–224, 1964–2 Cum. Bull. 52, the Service ruled that taxpayers who had been convicted of criminal antitrust violations could deduct amounts paid in satisfaction of treble damage claims and attendant attorney's fees. The Service's ground was that treble damage claims were "remedial in nature" rather than intended "to punish the wrongdoer." Regardless of whether the Service correctly concluded that antitrust treble damages were "remedial" rather than punitive, the principle would undoubtedly apply to a compensatory damage suit by the victim of a fraud or embezzlement.

tional right, not an additional penalty deriving from the institution of a criminal prosecution.

If a deduction is permitted for respondent's attorney's fees, his tax liability will be reduced, at least to the extent of the tax on the income which he used to pay the fees. In this respect the federal government would not be treating respondent's attorney's fees any better than it treats his other expenses of earning income. One of the Code's basic principles is that ordinarily no tax will be levied on income which is used to pay business expenses, *i.e.*, that only net income remaining after the payment of expenses will be taxed. This reflects the Code's underlying concept that the amount of tax due should be based on ability to pay, which in turn depends on the amount of income a taxpayer has retained after paying the expenses necessary to earn that income.[17a] A deduction will be disallowed for a business expense which otherwise satisfies the requirement of § 162 only when there is a clearly overriding policy. Such is the case, under decisions of this Court, with fines and penalties and payments which are themselves illegal. However, we acknowledge serious doubt that such an overriding policy in favor of disallowance exists with respect to attorney's fees incurred in unsuccessfully defending a criminal proceeding directed to offenses which are business-related.

[17a] See 50 Cong. Rec. 3849, quoted in part, *infra*, p. 24.

II

THE GOVERNMENT ACQUIESCES IN THE VIEW THAT, CONSIDERATIONS OF PUBLIC POLICY APART, RESPONDENT'S FEES MAY BE VIEWED AS SATISFYING THE REQUIREMENTS THAT THEY BE "ORDINARY AND NECESSARY" AND NOT PRIMARILY PERSONAL IN NATURE

A prerequisite to deductibility under the Code is that respondent's expenses were primarily business-related, rather than personal, and that they were "ordinary and necessary" in the sense that those words are used in the Code. The court below concluded that these requirements were met. The Commissioner does not seriously challenge this aspect of the Second Circuit's decision. Ordinarily, therefore, it would seem unnecessary to go further. However, there are numerous decisions of the courts which have denied deductibility and have rested, at least in part, on the view that a payment of the kind here in issue does not meet the above-stated requirements. Some statements of this Court also appear to suggest this. For these reasons, we deem it appropriate to set forth the arguments, pro and con, bearing on the "ordinary and necessary" and "personal" issues—issues which are somewhat related to the public policy question discussed above and are in all events within the framework of this litigation.

A. PERSONAL VERSUS BUSINESS EXPENSES

Expenditures that are motivated primarily by personal rather than business considerations must un-

questionably be disallowed. 1954 Code § 262.[18] However, whether the expenses of resisting a lawsuit are to be treated as essentially personal or are sufficiently business-related to be deductible depends not upon the suit's "potential consequences upon the fortunes [or liberty] of the taxpayer," which are certainly "personal" here, but rather upon "the origin and character of the claim," *i.e.*, "whether or not the claim *arises in connection with* the taxpayer's [business or] profit-seeking activities." *United States* v. *Gilmore*, 372 U.S. 39, 48–49 (emphasis in original); see also, *e.g.*, *United States* v. *Patrick*, 372 U.S. 53; *Lykes* v. *United States*, 343 U.S. 118; *Deputy* v. *du Pont*, 308 U.S. 488, 494, 496.

Thus, whether a taxpayer's expenses of defending a personal injury suit will be treated as personal or business in nature depends solely on whether the taxpayer was engaged in personal or business endeavors at the time of the accident out of which the suit arose. If the taxpayer was a sole proprietor driving his delivery truck on a business errand at the time of the accident his expenses of defending a tort suit have "a business origin" (*United States* v. *Gilmore*, *supra*, p. 45); and if all of the other requisites for deductibility are satisfied the legal fees will be deductible under § 162. If, on the other hand, the taxpayer, at the time of the accident in question, was driving his automobile on a personal trip, "the

[18] Some of the early administrative determinations disallowed legal expenses incurred in unsuccessfully defending business-origin crimes on the ground that they were personal. See O.D. 952, 4 Cum. Bull. 209 (1921); S.R. 3137, IV–1 Cum. Bull. 170 (1925).

source of the [tort] claim" would be personal (*United States* v. *Patrick, supra,* at 57), and the fees of defending it non-deductible.

While it could be argued that the origin of respondent's legal fees was his willful criminal act—and thus that they have a personal rather than a business origin—we do not think that this is the meaning of the *Gilmore* line of decisions. Rather those cases, as well as the relevant policy considerations, indicate that in determining the origin of litigation expenses the question is whether the activities that gave rise to the suit were intended to produce a profit,[19] on the one hand, or were primarily personal activities on the other. The criminal prosecution here in question was based on false and fraudulent representations which respondent made in an effort to sell securities. Whether respondent is regarded as being engaged in two businesses—the lawful sale of securities and the fraudulent sale of securities—or whether he is viewed as being in only one business—the sale of securities by either lawful or unlawful means—we believe that respondent's business activities were "the source of the claim" (*United States* v. *Patrick, supra,* at 57), and the resulting legal fees arose out of or "in connection with" his business.

[19] If the profit-seeking activities rise to the level of a trade or business, § 162 would be the relevant deduction section; if they do not qualify as a trade or business, it would be § 212. In either event the considerations are essentially the same. See *infra*, p. 25.

Nor is it relevant that the consequences of losing the lawsuit had a direct effect on respondent's personal life, *i.e.*, a jail term of 4½ years, since deductibility turns on "the origin * * * of the claim" rather than "on the *consequences* that might result to a taxpayer * * *" from loss of the suit. *United States* v. *Gilmore, supra,* at 48, 49 (emphasis in original).[20]

B. THE REQUIREMENT OF "ORDINARY AND NECESSARY"

1. Even if a particular expenditure is primarily business rather than personal in nature, it must, in order to be deductible, qualify as an "ordinary and necessary expense * * * [of] carrying on [a] trade or business" (Int. Rev. Code of 1954, § 162(a)). As we view § 162, these words are intended primarily to distinguish between recurring expenses of the taxpayer's business activities, on the one hand, and capital or primarily personal expenditures on the other. This Court has always interpreted the word "necessary" in a liberal manner, well designed to carry out the statute's purpose. Rather than giving "necessary" a strict definition such as "essential" or "indispensable" (Webster's New Collegiate Dictionary, p. 561 (1959 ed.)), the Court has regarded any expense

[20] Moreover, to disallow respondent's expenses on the ground that they were personal would result in a sharp difference in tax treatment between legal fees incurred by a taxpayer doing business in an unincorporated form and those of a corporate taxpayer (*e.g.*, in a criminal antitrust suit). Presumably none of the latter's expenses could be disallowed as personal. If, however, the Court concludes that such expenses do not qualify as "ordinary and necessary" or that their allowance would frustrate public policy, individual and corporate taxpayers would be treated alike.

as "necessary" within the meaning of § 162 and its predecessors if it is "appropriate and helpful" in "the development of the petitioner's business." *Welch* v. *Helvering,* 290 U.S. 111, 113; see, also, *e.g., Lilly* v. *Commissioner,* 343 U.S. 90, 93–94; *Commissioner* v. *Heininger,* 320 U.S. 467, 471. However, in defining "ordinary" the Court has at times appeared to require that an expense also be "of common or frequent occurrence in the type of business involved." *Deputy* v. *du Pont,* 308 U.S. 488, 495.

As stated *supra,* pp. 8–9, 21, the deductibility of expenses incurred in defending a lawsuit must be viewed in light of "the kind of transaction out of which the [suit] arose." Since fraud is presumably not common in the securities business, it becomes necessary to determine whether frequency is an essential ingredient of the "ordinary and necessary" concept.

While Congress did not focus on the issue, the legislative history of the Internal Revenue Code suggests that it intended no such prerequisite to deductibility. During the Senate debate in 1913 (the year the income tax was first enacted), Senator Williams, who was in charge of the bill, stated on the floor that it was designed to tax net business income:

> that is to say, what [a man] has at the end of the year after deducting from his receipts his expenditures or losses. It is not to reform men's moral characters * * *. [T]he purpose [is to make] * * * a man pay upon his net income, his actual profit during the year. [50 Cong. Rec. 3849.]

The Revenue Act of 1913 allowed a deduction for the "ordinary and necessary" business expenses of a corporation and the "necessary" business expenses of an individual. Revenue Act of 1913, c. 16, 38 Stat. 114, 166, §§ II(G)(b) (corporations) and § II(B) (individuals). Five years later, the word "ordinary" was added to the section covering individuals' deductions. Revenue Act of 1918, c. 18, 40 Stat. 1057, § 214 (a)(1). However it appears that this change was designed merely to make the language of the two sections consistent.[21] H. Rep. No. 767, 65th Cong., 2d Sess., p. 10; 4 Mertens, *Law of Federal Income Taxation*, § 25.01, fn. 2 (1960 Rev.).

In 1942, Congress added a new section to the Code, permitting taxpayers to deduct non-business "ordinary and necessary expenses" incurred in profit-seeking ventures. This Court has recognized that this new section (the predecessor to present § 212) was intended to grant a taxpayer engaged in a profit-seeking activity the same tax treatment as those engaged in a trade or business, with the sole exception "that the income-producing activity [need not] qualify as a trade or business." *United States* v. *Gilmore*, *supra*, at 45; *McDonald* v. *Commissioner*, 323 U.S. 57, 62; *Trust of Bingham* v. *Commissioner*, 325 U.S. 365, 373, 374. Accordingly, the legislative history of § 212, expressing Congress' understanding of "ordinary and necessary," is relevant in interpreting the

[21] One possible purpose of "ordinary" is to prevent capital expenditures from coming within § 162.

The two sections regarding business deductions of individuals and corporations were combined in 1928 (Revenue Act of 1928, c. 852, 45 Stat. 791, § 23(a)).

identical words in § 162. The Committee Reports on § 212's predecessor state that the purpose of the section is to allow a deduction "whether or not the expense is in connection with the taxpayer's trade or business, *if it is expended in the pursuit of income* * * *" and are "ordinary and necessary, which rule presupposes that they must be reasonable in amount and *must bear a reasonable and proximate relation to the production or collection of income* * * *." H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 46, 75 (emphasis added). To the same effect, see S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 87–88.[22]

We conclude, therefore, that if money "is expended in the pursuit of" a trade or business, it should not be disallowed solely on the ground that it is a novel type of expenditure or constitutes an innovation in the taxpayer's line of business. For example, if none of the competitors in a given line of business had ever before advertised their product because all were more or less fungible (*e.g.*, cranberries or potatoes), expenses incurred by a group of taxpayers who in good faith attempt to further their business by advertising designed to distinguish their product from the rest should not be disallowed. Similarly, the expenses of adopting automation should not be rendered nondeductible merely because the taxpayer was the first

[22] The Committee Report to an earlier draft of what eventually was enacted as § 212's predecessor stated that to be deductible an expense must be "immediately and directly incurred in the collection or production of income." Report of the House Ways and Means Subcommittee, dated January 14, 1938, 75th Cong., 3d Sess., pp. 46–47.

in his industry to adopt the practice.[23] If the Commissioner and the courts were required to disallow expenses solely because they were not common or frequent in the taxpayer's industry, business initiative and innovation would certainly be discouraged.[24] See

[23] Such an interpretation of § 162 would not require this Court to overrule any of its prior decisions. In *Welch* v. *Helvering*, 290 U.S. 111, the Court properly denied the taxpayer a deduction for his expenditures in payment of the debts of a predecessor corporation that had been discharged in bankruptcy. As the Court noted, these expenditures were "in the nature of capital expenditures, an outlay for the development of reputation and good will" (p. 113) and thus not deductible in the year paid in any event. In *Deputy* v. *du Pont*, 308 U.S. 488, the decision in which the language here in question first appeared, the Court properly denied a deduction for expenses incurred by a stockholder in obtaining stock for sale to executives of a company in which he owned 16% of the stock. The Code did not then permit a deduction for expenses incurred in a profit-making venture which did not qualify as a trade or business (*e.g.*, owning stock as an investor). The Court recognized that the stockholder's expenses were non-deductible because not incurred in *his* trade or business (pp. 493–494), and added the language here in question merely as dicta or alternative holding (pp. 494–496). In fact, the concurring Justices expressly disavowed this unnecessary language and relied solely on the taxpayer's lack of a trade or business (p. 499). Nor, of course, would disavowal of any requirement that an expense be common or frequent in the taxpayer's type of business change the result reached in *Lilly* v. *Commissioner*, 343 U.S. 90, where the opticians' payments to prescribing optometrists were held deductible. There, the Court found such payments to be customary in the industry and thus did not have to reach the question whether they would have been deductible if there had been no such established practice.

[24] In fact the Service and the Department of Justice have seldom advanced this argument except with regard to expenses which are immoral or illegal (such as in *Lilly* v. *Commissioner*, 343 U.S. 90, and *United Draperies, Inc.* v. *Commissioner*, 340

Lamont, *Controversial Aspects of Ordinary and Necessary Business Expense,* 42 Taxes 808, 835 (1964).

2. Even if an expense would appear to fit within these definitions of "ordinary and necessary" it must also bear a "direct and proximate" relationship to the taxpayer's business. See *Kornhauser* v. *United States,* 276 U.S. 145, 153; *Trust of Bingham* v. *Commissioner,* 325 U.S. 365, 370, 374. See also H. Rep. No. 2333, 77th Cong., 2d Sess., p. 75, quoted and discussed, *supra,* p. 26. In other words, an expense may have its ultimate origin in a business purpose, yet be deemed too remote to qualify. For example, if an attorney joined a country club to which his more successful brethren at the bar belonged solely because he expected the resulting "shop talk" to increase his legal knowledge and standing, and thus further his business, the tax law ought not to permit a deduction for his dues. Taxation is a practical matter, and to attempt to separate out and attach significance to every element of business advantage accruing from the processes of living—especially living in a world in which business and pleasure are often inextricably woven together—would prove fruitless. Although

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F. 2d 936 (C.A. 7), certiorari denied, October 11, 1965), and the Treasury Regulations promulgated under § 162 do not even mention any requirement that expenditures must be common or frequent in the taxpayer's industry. See Treas. Regs. §§ 1.162-1 through 1.162-19.

Nor do we believe that this Court's definition of "necessary" as "appropriate and helpful" implies that an expenditure which is reasonably intended to further the business' goal of making a profit must survive some court's moral judgment of business propriety.

activities of this kind may be helpful in furthering a taxpayer's business and he may have engaged in them primarily for business rather than personal or social reasons, the relationship between such an activity and the taxpayer's business is too intangible and remote to be described as "proximate" or "direct" or "ordinary."

It might be argued in similar vein that any expenses incurred in connection with a criminal prosecution should be non-deductible (wholly apart from the public policy doctrine considered above) because the criminal prosecution constitutes an intervening event sufficient to destroy the essential nexus between the expenses and the business. That is to say, there is something special about a criminal contest between a taxpayer and his sovereign that makes it peculiarly distinct and remote from its business or profit-seeking origin.[25]

One of the difficulties with this approach is that the expenses of defending a business-origin damage suit are generally deductible. *Kornhauser* v. *United States,* 276 U.S. 145; *Commissioner* v. *Heininger,* 320 U.S. 467; Rev. Rul. 64–224, 1964–2 Cum. Bull. 52. The institution of a civil damage suit is not a sufficient intervening force to make the fees and damages too remote even where the acts which gave rise to the civil suit were also criminal. See *Commissioner* v. *Heininger, supra;* Rev. Rul. 64–224, *supra.* Unde-

[25] Whether this argument, if accepted, would apply only where the taxpayer was convicted, or would apply whenever a criminal prosecution was the cause of the expenses need not now be decided, for in any event, by virtue of his criminal conviction, respondent would be covered.

niably, many public welfare statutes which impose punitive sanctions upon a business enterprise do not require any more proof of intent or culpability than a civil suit.[26] The principal difference between a prosecution of that type and a civil action is the sovereign's decision that, in addition to civil liability, the offender should be punished. Blanket disallowance of all expenses related to a criminal case of this kind might impose an additional penalty on the taxpayer out of all proportion to the seriousness of the offense or the penalty set by the legislature or the convicting court. Accordingly, we doubt that the expenses of defending a criminal prosecution should be considered too remote from the business activities which gave rise to them while the expenses of defending a similar civil suit will be regarded as sufficiently "direct and proximate."

[26] The Court has nevertheless declined in a closely related context to distinguish between wilful and inadvertent crimes. See *Hoover Motor Express* v. *United States*, 356 U.S. 38.

CONCLUSION

If the Court agrees with the Commissioner's long-standing position that attorney's fees incurred in the defense of an unsuccessful prosecution are non-deductible, the judgment below should be reversed. If, however, the Court concludes that the public policy doctrine should not be applied to that situation, the conflict among the circuits should be resolved by an affirmance of the Second Circuit's judgment.

Respectfully submitted.

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DECEMBER 1965.

*In lieu of the Solicitor General, who has disqualified himself.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No. 351

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

—v.—

WALTER F. TELLIER and EVELYN H. TELLIER.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENTS

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BRIEF FOR THE RESPONDENTS

Opinions Below

The memorandum opinion of the Tax Court (R. 4) is not officially reported. The opinion of the Court of Appeals (R. 10) is reported at 342 F. 2d 690.

Jurisdiction

The judgment of the Court of Appeals was entered on February 16, 1965 (R. 20). Mr. Justice Harlan extended the Commissioner's time for the filing of a petition for writ of certiorari to July 16, 1965 (R. 22). Certiorari was granted on October 11, 1965 (R. 23). The Court's jurisdiction is invoked under 28 U. S. C. §1254(1).

Question Presented

When the Commissioner admits that expenditures for a defense against criminal charges are otherwise ordinary and necessary expenses paid in carrying on a trade or business, may he, nevertheless, disallow a deduction for such expenditures for the sole reason that the defense failed?

Statute Involved

Internal Revenue Code of 1954:

Sec. 162. TRADE OR BUSINESS EXPENSES.

(a) IN GENERAL.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *.

SUMMARY OF ARGUMENT

POINT I

A & B. The contention that "overriding public policy" requires the disallowance of counsel fees paid in an unsuccessful criminal defense, though such fees otherwise fully satisfy the statutory requirements for allowance, has never enjoyed full judicial support. The chronological table (appendix, pp. 37-39 *infra*) establishes that beginning with 1924, the Board of Tax Appeals apparently supported the Commissioner's contention, but that a conflict in the courts of appeals developed immediately. Thereafter, both the Tax Court and the Commissioner accepted this Court's decision in *Commissioner* v. *Heininger,* 320 U. S. 467 (1943),

which had resolved the conflict, as dispositive of the issue, regardless of whether the fees had been paid for a defense in an administrative hearing or in a criminal trial.

Thereafter, the issue seems to have disappeared as a cause for litigation, until the Tax Court revived it in 1956, by making the distinction between administrative and judicial proceedings. However, there does not seem to be a single later decision of any court other than of the Tax Court in which "overriding public policy" has been applied as the basis for disallowance of counsel fees.

The Commissioner's unqualified support of the view that *Heininger* had laid the issue completely to rest is proved by the fact that such was the thrust of G. C. M. 24377, 1944 CUM. BULL. 93, issued in 1944. The Commissioner's official position remained unchanged until G. C. M. 24377 was modified in 1962 by Revenue Ruling 62-175 (1962-2 CUM. BULL. 50). Consequently, contrary to the suggestion made by the Acting Solicitor General, the government's official position that "overriding public policy" requires the disallowance of certain counsel fees really dates no earlier than 1962. (The original decision by the Board of Tax Appeals in 1924 did not enforce a formally issued Commissioner's ruling.)

However, when the 1954 recodification of the Internal Revenue Code was enacted, it was G. C. M. 24377, and not Revenue Ruling 62-175, that stated the Commissioner's official interpretation of the statute. Since the pertinent section was reenacted unchanged, the presumption of ratification attaches to G. C. M. 24377, and it should be presumed that Congress intended no such distinction between administrative and criminal proceedings as was drawn by the Tax Court.

C. It is submitted that this Court's decisions on the overall question of the validity of "overriding public policy" as a basis for disallowances do not support the belief that it will approve its application to attorney fees. Since *Textile Mills Securities Corporation* v. *Commissioner,* 314 U. S. 326 (1927), the decisions would rather suggest an integrated policy of restricting expansions in the area of application of "overriding public policy."

POINT II

The same observation would nevertheless seem to be true of *Tank Truck Rentals, Inc.* v. *Commissioner,* 356 U. S. 30 (1958), though it disallowed fines on the ground that such disallowance was required by public policy. It is suggested that the decision represents the resolution of a unique problem, and should not be extended beyond the narrow necessities of the facts in that case.

Indeed, the use of a public policy contention in connection with counsel fees is singularly inappropriate. While it is possible to say of lobbying expenses that they were outside the sanction of law, and of the taxpayer's practice of balancing the tax cost of fines against the economic cost of observance of law that such activity could not be countenanced, denunciation of the use of counsel in a defense against criminal charges is completely unthinkable. Not only is it unthinkable, but no conclusion is possible other than that public policy supports and encourages the use of counsel in those circumstances.

Moreover, there is singular vice in any contention that analogizes fines with expenditures for counsel for the express purpose of attributing to the tax burdening of

the employment of counsel the same efficacy to suppress crime as it does in the case of fines. And, to justify that analogy, particularly, by claiming support in this Court's decision in *Tank Truck Rentals, Inc.* v. *Commissioner, supra,* is to deny the plain record of this Court's devotion to the principle that the right of an accused to counsel is a noble and distinguishing feature of our law.

POINT III

A. The Commissioner has discriminately selected the deduction of counsel fees in criminal proceedings for exclusive application of the "overriding public policy". Such fees, however, are the only fees that are specifically within the area of protection by a Constitutional guarantee. Therefore, his claim of support of Congressional intent brings the controversy within Constitutional stature, because it must be presumed that Congress would not abridge a Constitutional guarantee.

B. Although it is no longer certain that Congress discharges its obligation under the Constitutional guarantee of counsel for defense in a criminal proceeding simply by remaining neutral, the corollary question whether Congress is obliged to subsidize the Constitutionally protected right is not present here. That is so, because allowance of a business deduction does not subsidize a taxpayer. On the other hand, the economic effect of a disallowance of a business deduction is clearly and definitely a penalty. The revenue does not suffer a single penny loss when an otherwise deductible business expense is allowed by the Commissioner, but it does exact an additional amount when the deduction is disallowed.

The disallowance of such loss creates fictitious income, thus destroying the integrity of the tax law. Thereafter, the taxpayer's taxable income no longer bears any relation to his real income. Inevitably, the taxpayer's liability for taxes is fixed by the size of the disallowance and the taxpayer's total income rather than by his real income or by his ability to pay. Hence, application of "overriding public policy" makes a mockery of the basic sociological advance incorporated in the tax law that the cost of government should be borne in proportion to ability to pay. Congress, it is submitted, did not intend to perpetrate a monstrous deceit.

C. The fact that the Commissioner applies the penalty of "overriding public policy" exclusively to counsel fees in criminal prosecutions, and not to any other business expense remotely related to an illegal act, is proof enough that the Commissioner is engaged in a discriminatory policy that would amount to abridgment of the Constitutional guarantee, were it sanctioned by Congress. But, the vice of the Commissioner's policy strikes even deeper.

The penalty of a large and frequently financially crippling additional tax that results when a true business expense is transmuted into fictitious income by the disallowance of a business expense must be paid out of the taxpayer's real resources. No deduction for any other business expense is subjected to the same hazard of fate as is the deduction for counsel fees in a criminal proceeding. Of all the deductions that may arise out of the act that resulted in the charge, only the taxpayer's deduction for counsel fees is dependent on his victory in court. Moreover, the relative size of that tax penalty is determined by the degree of resistance with which he meets the charge. The

more he resists, the larger his cost of defense, and the greater his tax penalty, should he lose.

Indeed, the taxpayer treads a cycle. He cannot plan his defense unless he knows what resources are available for the defense; and he does not know the latter until the last appeal has been decided, because until that decision is made, he cannot foretell whether he was or was not able to devote all his funds to his defense.

The Commissioner forces the taxpayer to put up the penalty as a stake, before he elects to defend against the charges. The Commissioner adds a hazard, not to the outcome of the trial, but to the choice of whether or not to defend. He forces the taxpayer to consider the possibility of a tax penalty at every stage of the defense. It can have no other effect than to exert pressure against the choice of defending.

A government that subjects a taxpayer to an additional and further penalty for the sole reason that he elected to defend himself against a charge of a crime—and lost, is enforcing a medieval concept of justice. Surely, Congress would have no part of it.

ARGUMENT

I.

The Commissioner incorrectly claims acceptance of the view that, by itself, defeat in any criminal prosecution works a forfeiture of the taxpayer's statutory right to deduct attorney fees.

A. *The Tax Court Belatedly Revived a Discredited Doctrine*

The government's initial drive to get this Court's approval for the doctrine that a lost defense against charges of misconduct makes counsel fees invariably nondeductible was halted in *Commissioner* v. *Heininger,* 320 U. S. 467 (1943). In that case, the Commissioner had disallowed counsel fees incurred by a dentist in an unsuccessful effort to reverse a departmental order barring him from access to the mails because his mailings had been found to be fraudulent and misleading. The Board of Tax Appeals sustained the Commissioner under the mistaken idea that the denial of the deductions was required as a matter of law.[1]

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[1] As the following shows, this Court did not view the Board's decision as part of a firmly established rule, consistently followed by the Board: " . . . [the Board] did not deny the deductions claimed by respondent upon *its own interpretation of the words "ordinary and necessary"* as applied to its findings of fact. . . . The interpretation it adopted was declared to be required by the Second Circuit's reversal of the Board's view in *National Outdoor Advertising Bureau, Inc.* v. *Commissioner,* 32 BTA 1025. . . ." *Commissioner* v. *Heininger,* 320 U. S. 467, 470-471 (1943). " . . . the Board of Tax Appeals here denied the claimed deduction not by an independent exercise of judgment but upon a *mistaken conviction that denial was required as a matter of law. . . .*" *Id.* at 475. (Italics supplied.)

In support of his position, the Commissioner had argued: (1) That it is not an ordinary and necessary expense of doing business to employ counsel in defense of charges of violation of law, (2) That carrying on a business means doing business lawfully, so that unlawful action must be considered as the personal wrong-doing of the taxpayer, and (3) That even if the Commissioner were wrong in the first two contentions, the counsel fees were nevertheless nondeductible because of the connection of those fees with the taxpayer's wrong-doing.

The Court rejected all three contentions. To the first, the Court replied that since the law-suit was clearly the direct result of the taxpayer's business, and since it is the normal procedure to employ counsel in a law-suit, the fees paid to such counsel certainly were ordinary and necessary expenses of doing business. Of the second contention, the Court said that the "reasoning, though plausible, is unsound . . ." because it is both ordinary and necessary for a taxpayer to try to protect the very existence of his entire business. (*Id.* at 472.)

The third contention produced the remote relation rule (*id.* at 474), which, it is submitted, may be paraphrased as follows: There has never existed any rule of law that makes an otherwise deductible expense nondeductible only because such expense has a secondary relation to an unlawful act.

Since the counsel fees had been incurred in a law-suit that was the proximate result of the taxpayer's business, deductibility was not forfeited simply because it was the taxpayer's misconduct that had created the law-suit.

Although the precise holding of *Heininger* is that the cost of an unsuccessful defense against an administrative de-

termination of violation of law is not barred by reason of considerations of public policy, the reasoning is broad and general, applying equally to counsel fees in any law-suit. That it was so then understood, there is no doubt, as is established by the subsequent action of both the Tax Court and the Commissioner.

The very next year, the Tax Court decided *Longhorn Portland Cement Company*, 3 T. C. 310 (1944), holding that *Heininger* required the allowance of deductions for counsel fees and fines resulting from an uncontested state prosecution for violation of state antitrust statutes. The Commissioner acquiesced in the part of the decision allowing such counsel fees (A., 1944 CUM. BULL. 43), but appealed from the Tax Court's allowance of the fines.[2] The Commissioner also published G. C. M. 24377, 1944 CUM. BULL. 93, in which *Heininger* was read as requiring the allowance of deductions for counsel fees in an unsuccessful defense against criminal charges of violation of the Sherman Antitrust Act.

At this point, since both the Tax Court and the Commissioner had agreed that within the rule of *Heininger*, the cost of an unsuccessful defense against charges of misconduct, whether brought in a criminal court or before an administrative agency, was deductible (provided the matter was the proximate result of the taxpayer's business), the law was well-settled on the basis of the *Heininger* rule. And, the law remained that way, well-settled, from 1943 to 1956, a period of 12 years.

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[2] In *Commissioner* v. *Longhorn Portland Cement Company*, 148 F. 2d 276 (5th Cir. 1945), the allowance of fines was reversed.

Not until *Thomas A. Joseph*, 26 T. C. 562 (1956), did the Tax Court have a change of heart.[3] In that decision, the Tax Court for the first time propounded the distinction between administrative determinations of guilt and verdicts of criminal guilt. The Tax Court reasoned that since the context of the *Heininger* decision was that of an administrative determination, and since this Court had listed *Burroughs Bldg. Material Co.* v. *Commissioner*, 47 F. 2d 178 (2d Cir. 1931), in footnote 8 (320 U. S. 467 at 473), it was apparent (to the Tax Court) that the *Heininger* principle applied only to administrative determinations and that this Court had intended to preserve the *Burroughs* rationale by its citation of that decision in the footnote.[4]

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[3] In the intervening case of *Anthony Cornero Stralla*, 9 T. C. 801, 820-821 (1947), the Tax Court held that deductions for legal fees and fines resulting from the illegal operation of a gambling ship were barred by the public policy doctrine. It distinguished *Heininger* on the basis of a distinction between expenses resulting from an unlawful act in a lawful business and lawful expenses in an illegal business. ("... [u]nlike the *Heininger* case, the business here carried on, ... was illegal.") In *Longhorn*, like in *Heininger*, the business had been lawful. (The *Stralla* distinction was swept away in *Commissioner* v. *Sullivan*, 356 U. S. 27 (1958).)

[4] The Tax Court overlooked that *Burroughs Bldg. Material Co.* v. *Commissioner, supra*, had been listed in the very same footnote in which *Helvering* v. *Superior Wines & Liquors, Inc.*, 134 F. 2d 373 (8th Cir. 1943) had also been listed as analogous in principle with *Burroughs*. (This Court cited the latter after the signal "cf." apparently only to indicate that it differed from *Burroughs* by reason that whereas *Burroughs* disallowed attorney fees after conviction, *Superior Wines* went further to also disallow attorney fees in any law-suit involving a "penal" statute even such that had been settled by compromise of penalties.) Since certiorari had been granted in *Heininger* (*Commissioner* v. *Heininger*, p. 13, fn. 5, *infra*) to resolve the conflict with *Superior Wines*, it seems plain that the Court also indicated that it was reviewing the reasoning of the decision in *Burroughs* as well as the decisions in the two cases in which certiorari had been granted. Because this Court reversed *Superior*, it should be plain that the principle of *Burroughs* was thereby also rejected.

With the *Joseph* decision, the Tax Court, therefore, reversed its position and revived the public policy doctrine in the case of counsel fees (when the business itself was lawful) as an instrument to destroy the deductibility of counsel fees in an unsuccessful criminal defense.

The Commissioner, however, held back for another 6 years. Not until 1962, did the Commissioner publish Revenue Ruling 62-175, 1962-2 CUM. BULL. 50, in which the Tax Court's distinction between administrative and criminal determinations was finally formally accepted, and counsel fees in unsuccessful defenses against criminal charges of violation of the antitrust laws were thereafter ruled to be nondeductible. The Commissioner also explained his reversal of policy by the statement that in G. C. M. 24377, he had erred in the application of the *Heininger* rationale.

Hence, it is quite plain the government is wrong to claim 40 years of acceptance for the application of a rule that counsel fees in an unsuccessful criminal defense are unallowable because of "overriding public policy" (Pet. Br. pp. 3, 6). The truth is that the policy had never been accepted by this Court, the Tax Court did not enforce it in the case of a lawful business between 1944 and 1956, and the Commissioner, himself, had entirely abandoned it between 1944 and 1962.

B. *Since Heininger, No Court Supports the Revival of the Doctrine*

The government also errs in claiming the endorsement of "every court of appeals that had passed upon the question, as well as . . . the Court of Claims . . ." (Pet. Br. p. 4). The government completely misreads the story told by its own citation of authorities in footnotes 5, 6 and 7 (Pet. Br. p. 4).

Burroughs Bldg. Material Co. v. *Commissioner,* 47 F. 2d 178 (2d Cir. 1931) and *National Outdoor Advertising Bureau* v. *Helvering,* 89 F. 2d 878 (2d Cir. 1937) were both pre-*Heininger* cases. To this list, the government should properly add *Heininger* v. *Commissioner,* 133 F. 2d 567 (7th Cir. 1943) in which case the Seventh Circuit had rejected the doctrine.[5]

Footnotes 6 and 7 (Pet. Br. p. 4) list the post-*Heininger* decisions. However, the earliest case cited is *MacCrowe's Estate* v. *Commissioner,* 240 F. 2d 841 (4th Cir. 1956). Naturally, there is none between *Heininger* and 1956, the period during which the doctrine was a dead issue in both the Tax Court and in the Commissioner's office. More significant, however, is the fact that though these post-*Heininger* decisions disallow counsel fees, not one, as is shown below, bases its conclusion on "overriding public policy."

Every such cited case, but the two Fourth Circuit cases, involves the deduction of counsel fees incurred in prosecutions for filing false personal income tax returns. Of these, so involving the filing of false income tax returns, all except *Hopkins* v. *Commissioner,* 271 F. 2d 166 (6th Cir. 1959) presented the distinctly different question whether the cost of defending a charge not related to the taxpayer's business became a business expense because conviction of

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[5] Certiorari was granted in *Commissioner* v. *Heininger, supra,* to resolve the conflict between the Seventh and Second Circuits. Indeed, the Tax Court relied on that very fact in its *Longhorn Portland Cement Company* decision (3 T. C. 310, 318 (1944)). The Tax Court reasoned that since certiorari had been granted to resolve the conflict with the Second Circuit's decision in *National Outdoor Advertising Bureau,* affirmance of the Seventh Circuit's decision could mean only that the view of the Second Circuit had been rejected (also see p. 11 *supra,* fn. 4).

that charge would destroy the business. Hence, the question really involved the proximate relation rule of *Kornhauser* v. *United States,* 276 U. S. 145 (1927). Although the Commissioner may have also argued "overriding public policy" in these cases, the decisions were all bottomed on the threshold question of proximate relation and not on "overriding public policy."

Indeed, in *Port* v. *United States,* 163 F. Supp. 645 (Ct. Cl. 1958), and in *Tracy* v. *United States,* 284 F. 2d 379 (Ct. Cl. 1960), the Court of Claims was very precise in placing its decisions on the basis of the failure of the taxpayers to satisfy the proximate relation rule established in *Kornhauser* v. *United States, supra,* and not on the Tax Court's public policy doctrine (*Tracy* v. *United States, supra* at 381).

In *Bell* v. *Commissioner,* 320 F. 2d 953 (8th Cir. 1963), too, the Court said that the effect of a conviction on the taxpayer's accounting practice was an insufficient basis for allowance of the counsel fees, because the prosecution for filing a false tax return did not result from a business act or activity, but rather from the taxpayer's "personal misconduct."

In *Acker* v. *Commissioner,* 258 F. 2d 568 (6th Cir. 1958), the Court supplied only a laconic affirmance of the Tax Court's decision, but in the affirmed decision (T. C. Memo. 1957-18 (1957), 16 CCH Tax Ct. Mem. 89), even the Tax Court did not apply the public policy doctrine, but rather held that the effect of a tax conviction on an attorney's practice was only incidental, the conviction not having resulted from the taxpayer's professional activities. The other Sixth Circuit decision, *Hopkins* v. *Commissioner,* 271

F. 2d 166 (6th Cir. 1959), supplies no precedent. The posture of the controversy was that the taxpayer merely asked for allocation of legal fees between the services performed by the attorney in civil matters and in an effort to forestall indictment for filing a false return.

In *Peckham* v. *Commissioner,* 327 F. 2d 855 (4th Cir. 1964), the Court disallowed counsel fees incurred by a physician convicted of criminal abortions. The Sixth Circuit distinguished between abortions medically required and those defined as criminal. It held the latter to be personal acts and not within the taxpayer's profession. Having thus decided, the Sixth Circuit refused to discuss the public policy issue (at 856).

None of the cases cited by the government was decided by application of "overriding public policy"; hence, it is apparent that there is no post-*Heininger* support for that policy in any of the courts of appeals, nor in the Court of Claims. Only the Commissioner and the Tax Court cling to the discredited doctrine. Indeed, in the circumstances of the Commissioner's acquiescence that respondent's expenses satisfy the statutory criterion (Pet. Br. pp. 20-30), respondent would have been successful in any one of those courts.

Lastly, it is submitted, Congress was certainly aware of the construction placed upon the business expense section (Int. Rev. Code of 1939, §23(a)) by the Commissioner (Pet. Br. p. 14), especially when the 1954 recodification was enacted. However, at that time G. C. M. 24377, and not Revenue Ruling 62-175, stated the Commissioner's official interpretation of the statute, and the Tax Court had not yet glimpsed the error it was later to find in *Longhorn Port-*

land Cement Company, supra. Surely, if the Commissioner had then felt that G. C. M. 24377 expressed an incorrect interpretation adopted only because of the superior authority of *Heininger,* he would have requested corrective legislation. And, had Congress felt that the opinion expressed in G. C. M. 24377 needed nullification, the 1954 recodification would have afforded the most convenient opportunity.

It is submitted that the re-enactment of an unchanged criterion for the deduction of business expenses in the 1954 recodification at a time when both the Tax Court and the Commissioner agreed on the interpretation expressed in G. C. M. 24377 constituted a ratification of that interpretation.

C. *This Court's Decisions Since Heininger Establish That It Favors Restrictions on Any Use of the Public Policy Doctrine as a Reason for the Disallowance of Deductions*

In *Textile Mills Securities Corporation* v. *Commissioner,* 314 U. S. 326 (1927), this Court sustained the Commissioner's disallowance of various expenses that had been incurred for lobbying purposes. The Commissioner had, by Regulation, ruled that lobbying expenses were nondeductible. The Court said that there is no reason why "the rule-making authority" cannot recognize the Congressional purpose to eliminate lobbying by drawing a line between legitimate business expenses and those arising from that family of contracts to which the law has given no sanction. The "overriding public policy" doctrine thus entered into the tax law in the form of approval of an

exercise of administrative rule-making authority to determine deductibility.[6]

When, however, the Commissioner sought to extend that approval to include authority to disallow deductions that had only a remote relation to an unlawful act, this Court was not so willing to approve. In *Heininger* v. *Commissioner*, 320 U. S. 467 (1943), the Court placed the first limitation on the public policy doctrine by containing it within the area of specifically outlawed, as opposed to merely tainted, expenditures.

Too, it was inevitable that the Commissioner would also seek to enlarge the area of outlawed expenses beyond that of those prohibited by Congress. That, too, failed to secure this Court's approval, and, again, in *Lilly* v. *Commissioner*, 343 U. S. 90 (1951), the Commissioner was restricted to only those expenses that were by specific statute outlawed either by Congress or by the legislatures of the various states.

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[6] It is suggested that *Textile Mills* was influenced by the Court's preoccupation with the task of establishing the law of administrative agencies. However, the Commissioner's authority differs considerably from that of a regulatory agency; his general responsibility is rather to administer and interpret the tax law. It is well-settled, today, that the Commissioner cannot make rules either to permit or to "prohibit" deductions. (It is significant that in *Textile Mills Securities Corporation* v. *Commissioner, supra* at 337, the Regulation was characterized as prohibitory.)

The fact that the Commissioner has not promulgated a regulation prohibiting the deductions in the instant case (Pet. Br. p. 13) only proves that he has not had the "hardihood" (*Heininger* v. *Commissioner*, 133 F. 2d 567, 570 (7th Cir. 1943)) to usurp legislative authority to write another prohibitory regulation, and that he had fully accepted the *Heininger* principle. Indeed, he published his acceptance in an interpretive general counsel memorandum (G. C. M. 24377) which is only of slightly lower prestige than a regulation.

In the next case, *Cammarano* v. *United States,* 358 U. S. 498 (1959), the Regulation prohibiting lobbying expenses was again in issue. It has been suggested that the decision was influenced more by the unchanged Regulation which had been in effect since 1918 without Congressional repudiation than by enchantment with the public policy doctrine.[7] However, whereas Congress seemingly had acquiesced in both the Regulation and in *Textile Mills,* the *Cammarano* approval of the Commissioner's view of the same Regulation brought specific and adverse reaction from Congress.[8]

The last words on the subject were said by this Court in the companion cases of *Commissioner* v. *Sullivan,* 356 U. S. 27 (1958) and *Tank Truck Rentals, Inc.* v. *Commissioner,* 356 U. S. 30 (1958). In the former, the Court pruned away two of the Commissioner's favorite contentions: (1) that the statutory language, "ordinary and necessary expenses incurred in a trade or business" is so ambiguous[9] that the unique interpretative skills of the Commissioner are required, and (2) that the well-settled principle that deductions may be denied by Congress creates some kind of presumption that a particular deduction has indeed been denied, requiring the taxpayer to prove the contrary.

In *Sullivan,* this Court recognized that the language of the statute derived from the market place and hence had

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[7] Staff of Joint Comm. on Internal Revenue Taxation, Income Tax Treatment of Treble Damage Payments Under the Antitrust Laws 7 (1965).

[8] Public Law 87-834, §3, amending Int. Rev. Code of 1954, §162 (76 Stat. 960, 973) effective Jan. 1, 1963. H. R. Rep. No. 1447, 87th Cong., 2nd Sess. (1962) pp. 16-18; S. Rep. No. 1881, 87th Cong., 2nd Sess. pp. 21-24 (1962).

[9] That the language of the statute is ambiguous is the fundamental premise of *Textile Mills* (314 U. S. at 338).

to be given its commonly accepted meaning (*supra* at 29). Additionally, in both *Sullivan* (*ibid.*) and in *Tank Truck Rentals* (*supra* at 35), the essential and indispensable function of deductions in the determination of a tax base which correctly measures the taxpayer's ability to pay was recognized in the statement that it is presumed that Congress had intended that the tax be levied on net and not gross income.

It is suggested that in *Sullivan,* this Court repudiated the reasoning of *Textile Mills Securities.* That it did not also repudiate its principle would seem to be attributable only to the fact that, as happened in *Cammarano* v. *United States, supra,* the Court probably remained impressed by the apparent Congressional acceptance of a regulation calling for the disallowance of lobbying expense.[10]

It is believed that no further question involving extension of the public policy doctrine would have been possible after *Sullivan,* were it not for *Tank Truck Rentals,* which despite the apparent acceptance of the reasoning of *Sullivan,* nevertheless, created an exception to the remote relation rule of *Heininger.*[11] However, it is also believed that *Tank Truck Rentals* is this Court's response to an extremely unique factual situation, but does not constitute a real relaxation of its determination to construe the business expense statute without any esoteric public policy

[10] Public Law 87-834 modifying the *Commarano* interpretation of the lobbying Regulation was enacted subsequent to that decision.

[11] Cf.: *Farnsworth* v. *Commissioner,* 270 F. 2d 660 (3rd Cir. 1959), *cert. denied* 362 U. S. 902; *Keystone Metal Company* v. *Commissioner,* 264 F. 2d 561 (3rd Cir. 1959).

complications.[12] Furthermore, it is suggested that the logic of *Tank Truck Rentals* cannot be carried over into the area of attorney fees.

II.

The reasoning of *Tank Truck Rentals* cannot logically be applied to support the disallowance of attorney fees.

A. The fact that the Court in *Tank Truck Rentals, Inc.* v. *Commissioner*, 356 U. S. 30, 35 (1958) felt the need to declare that the "standard" of remote relation established in *Heininger* required "flexibility" is proof that the Court considered that the *Heininger* rule had been established as a general rule, and that it was not specifically limited in any way to the specific facts in that case. Hence, it is apparent that the Court in *Tank Truck Rentals* generally classified fines as remotely related expenses that ought to be controlled by the *Heininger* rule, but excluded them by way of an exception. That reasoning therefore clearly also classifies the counsel fees here as remotely related expenses, to which the *Heininger* rationale is applicable, unless the rationale of *Tank Truck Rentals* constitutes them an exception, too.[13]

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[12] In *Sullivan* (*supra* at 29) the Court said, speaking of its rule that the statutory language of Section 162 should be given its accepted meaning,

> ". . . That is enough to permit the deduction, unless it is clear that the allowance is a device to avoid the consequence of violation of law, as in *Hoover Motor Express Co.* v. *United States, supra,* and *Tank Truck Rentals, Inc.* v. *Commissioner, supra,* . . ."

[13] These observations also establish that both the Tax Court in *Thomas A. Joseph*, 26 T. C. 562 (1956), and the Commissioner in Revenue Ruling 62-175, were wrong in emphasizing the fact that

Tank Truck Rentals, Inc. v. *Commissioner, supra,* carved out an exception to the *Heininger* rule. That exception is based squarely on the theory that the deduction of fines reduces the "sting" of such fines as a deterrent to crime (*supra* at 36). Therefore, the "severity and immediacy of the frustration resulting from the deduction" is almost equal to that accomplished by the offense itself (*supra* at 35), because "the allowance of a deduction for fines would but encourage continued violations of state law by increasing the odds in favor of noncompliance. . . ." (*Ibid.*)

Hence, it follows that unless the allowance of counsel fees will have a similar or equal frustrating effect on the policy expressed in the statute, the circumstances which prompted the *Tank Truck* exception are not present, and no reason exists for a further relaxation of the general *Heininger* rule to also disallow such fees.

The Commissioner obviously recognizes that, if the *Tank Truck* exception is to be carried over to counsel fees, it is incumbent upon him to establish an analogy between counsel fees and fines in connection with their effect on the potential of prohibitory statutes to achieve their ends. The Commissioner, therefore, argues, "Respondent's attorney's fees in connection with his criminal trial are intimately and inextricably connected with the entire legislative and judicial machinery for preventing, combating, and punishing crime. . . . Such expenses are no more remote from illegal conduct than the fine levied upon conviction, which this

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the counsel fees in *Heininger* had been expended in defense of charges tried before an administrative agency, and consequently in reading *Heininger* as establishing only a particular and not a general precedent.

Court has already held nondeductible in *Tank Truck Rentals. . . .*" (Pet. Br. p. 12.)

It is plain that the Commissioner is saying that the allowance of a deduction for counsel fees has the same deleterious effect on the realization of the policy goals of a statute as does the allowance of deductions for fines levied either to achieve conformance with, or to punish violations of, that statute. In the light of the reason given by this Court for the disallowance of fines, the Commissioner therefore uses the analogy with fines to really advance the argument that the allowance of counsel fees "would but encourage continued violations by increasing the odds in favor of noncompliance . . ." *Tank Truck Rentals, Inc.* v. *Commissioner, supra* at 35.

This is a noxious contention. It cannot be based on any statement made by this Court. Clearly, this Court had absolutely no conviction that it was thwarting the enforcement of penal statutes (or mitigating the punishment imposed by such statutes) when in *Gideon* v. *Wainwright,* 372 U. S. 335 (1963), it ruled that a defendant could not be tried for the violation of any penal statute unless he is represented by counsel, even if such representation had to be supplied at public expense.

Neither did a former Solicitor General, as amicus curiae on behalf of the American Civil Liberties Union in the same case, have any fear that he was encouraging criminality, when he urged that a defendant who has been deprived of counsel has not been tried by due process. (Brief for the American Civil Liberties Union, p. 7, *Gideon* v. *Wainwright, supra.*)

It is evident that the Commissioner misreads the rationale of *Tank Truck,* because he takes it out of its prece-

dential context. The true rationale can be discovered, it is suggested, only when proper consideration is also given (1) to this Court's statement in the companion case of *Commissioner* v. *Sullivan*, 356 U. S. 27, 29 (1958) that the deduction is allowable unless used as "a device to avoid the consequence of violation of a law, . . . as in *Tank Truck Rentals, Inc.* v. *Commissioner, supra*, . . . ", (2) to the finding in *Tank Truck Rentals, Inc.* v. *Commissioner, supra* at 33, that the taxpayer "deliberately operated" in an unlawful manner at a "calculated risk", and (3) to the statement in *Hoover Motor Express Co.* v. *United States*, 356 U. S. 38, 40 (1958), also a companion case, that the taxpayer made no effort to avoid violations of the statutes.

The decisions in *Tank Truck* and *Hoover Motor Express* express this Court's distaste for a taxpayer's policy of weighing the tax cost of fines against the tax cost of conformance with law. The Court obviously felt that in such circumstances, the tax cost of disallowance of fines should be added to the scale on the side of conformance with law. It is evident that the Court expressed an ethical judgment in relation to unique circumstances, but one which, if applied indiscriminately, can result only in mischief.

It is completely unfair to this Court to stretch what this Court said in those two cases so as to make it seem that this Court would say that the employment of counsel encourages criminality, or that the Constitutional guaranty of right to counsel must give way before an implied Congressional purpose that the tax law not be used to encourage violations of statutes. (That the idea that the allowance of deductions for counsel fees supplies a tax benefit is completely fallacious is discussed in Point III *infra*, pp. 26-28.) At least since *Johnson* v. *Zerbst*, 304 U. S. 458 (1938), no one can

say that this Court has not been zealous in the protection of the Constitutional guarantee of the right to counsel.

B. That same faulty logic which perverts this Court's statements into authority for the denial of the fundamental right to counsel for the purpose of suppressing illegality leads to the Commissioner's criticism of the Second Circuit's opinion for a failure to find a policy requiring the discouragement of employment of counsel within the proscriptive statutes themselves.

How could the Second Circuit find such purpose within those proscriptive statutes? This Court, in *Heininger* could not find it, either.[14] Instead, in *Heininger,* this Court, said that it was not the purpose of those proscriptive statutes to "deter" the employment of counsel in defense of charges of violation of those statutes, and that to disallow deductions for counsel fees would be "to attach a serious punitive consequence" which Congress had not indicated *in the statutes* themselves should result from the determination of guilt (320 U. S. at 474).

Whereas this Court had said that about a deduction for counsel fees in the context of an administrative hearing to

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[14] By no stretch of the imagination can it be visualized that any state statute contemplates that the Commissioner, a federal agency, will make disallowances on federal returns to punish infractions of the state statutes. Neither can it be contended that the Commissioner or the federal judiciary has the authority to determine which infractions of state law should, and which should not be so, punished. Nevertheless, that is one of the unexpected (and it is submitted, undesirable results that has followed from the decision in *Tank Truck Rentals, Inc.* v. *Commissioner, supra.* (*Keystone Metal Company* v. *Commissioner,* 264 F. 2d 561 (3rd Cir. 1959); Rev. Rul. 61-210, 1961-2 CUM. BULL. 162.) Cf. *Dukehart-Hughes Tractor & Equipment Co., Inc.* v. *United States,* 341 F. 2d 613 (Ct. Cl. 1965), where the Court of Claims was called upon to determine whether a state law made certain business acts unlawful.

determine guilt, the Second Circuit's statement, expressing the identical thought, was couched in Constitutional language, as was required by the fact that the counsel fees in this controversy had been expended in a criminal trial involving liberty and not merely money. The Second Circuit very properly said that since Congress could not put into any statute the purpose of denying the right to counsel without abridgment of the Constitution, it could not be presumed that Congress had intended to deny counsel fees as a punishment.

Moreover, the Acting Solicitor General says hardly less when he comments that the policy advocated by the Commissioner "would impose a penalty in proportion to the amount of the illegal expenditure and the taxpayers income tax bracket, rather than the seriousness of the offense committed" (Pet. Br. p. 16); for, that policy, too, would raise such grave Constitutional questions, that neither could it be presumed to be a Congressional purpose.[15]

C. Equally fallacious is the Commissioner's use of the principle in *United States* v. *Gilmore,* 372 U. S. 39, 49 (1963) to attempt to convince the Court that "respondent's legal fees are the direct and predictable result of his violations . . ." so that "their deductibility must be considered in the light of the public policy embodied in those statutes . . ." (Pet. Br. p. 9). The Court answered that contention in *Heininger* when it said (1) that the public policy embodied in those statutes does not include that of disallowance of counsel fees, and (2) that the attorney fees were the direct and predictable results of the law-suit and not

[15] Moreover, it would be completely at odds with the basic Congressional purpose that the cost of government be borne in proportion to financial ability.

of the violations. Counsel fees are only the remote results of the violations, and that was the very reason for the principle of *Heininger*. The Commissioner errs in calling counsel fees the direct result of the taxpayer's "violations."

III.

It cannot be presumed that Congress intended to abridge a constitutional right.

A. *The Commissioner Aims His "Overriding Public Policy" Argument Exclusively Against Counsel Fees in a Criminal Prosecution, Singling Out for Disallowance the Only Expense in This Case Which Is Protected by a Constitutional Guarantee*

In the circumstances of the Commissioner's concession that respondent's attorney fees fully satisfy all the statutory requirements for allowance as ordinary and necessary business expenses, it must also be taken as conceded that those fees have precisely the same statutory standing as any other expense incurred in carrying on respondent's business; viz., rent, wages, telephone, etc.[16] Nevertheless, attorney fees have been disallowed by the Commissioner, though such fees would have been allowed, had respondent been successful in defeating the criminal charge, or—re-

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[16] The Acting Solicitor General's assertion that the Second Circuit would agree that the expense of defending a suit arising out of personal acts is nondeductible and his quotation from the Tax Court's decision that Constitutional guarantees do not cause a transmutation of personal expenses into business expenses are completely irrelevant. No one has made contrary claims, and this controversy is not over the deduction of personal expenses. The taxpayer deducted the fees as a business expense, and the Commissioner's reason for disallowance was not that the fees were a personal expense, but that they were unallowable even though a business expense.

gardless of outcome—had the defense been in an administrative hearing even on the same statutory violations.[17]

The vital point is that of all the expenses that respondent has incurred in a single business (or that are incurred by any businessman), the Commissioner has selected only the expense which has Constitutional stature as his target.[18] Since the Commissioner claims that his action has the implied consent of Congress, and since, surely, it cannot be presumed that Congress intended to abridge a Constitutional right, the question inevitably becomes whether that policy of disallowance aimed exclusively at an expense, incurred in pursuit of a constitutionally protected right, constitutes an abridgement of that right.

That question, it is suggested, may be resolved on the basis of the economic impact of disallowances of business expenses. If a disallowance should make it more difficult, more costly, or impossible to incur the expense, the fact that *only* the Constitutionally protected expense has been so burdened surely establishes that a Constitutionally protected act has been economically discriminated against. The imposition of a discriminatory, additional and special tax

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[17] The Acting Solicitor General confirms that the Commissioner aims exclusively at attorney fees incurred in a lost defense against charges of a crime when he argues that disallowing only one out of all the remotely related expenses hardly amounts to taxing respondent's business on the basis of gross receipts (Pet. Br. p. 13, fn. 11). Parenthetically, it must be added that what the Commissioner seeks to do does not make respondent's business taxable on the basis of net income, either. Yet, it is the latter and not the former, that the statute intends.

[18] It may be noted that although the right to counsel is an administrative proceeding is specifically provided by statute (Administrative Procedure Act §6(a), 60 Stat. 237 (1946), 5 U. S. C. §1005), only in the case of a criminal charge does it fall squarely within the ambit of the Sixth Amendment.

on only the exercise of a Constitutionally protected right is not by any stretch of imagination equal to the adoption of the "hands-off" position towards that right (cf. *Cammarano* v. *United States*, 358 U. S. 498, 515 (1959) separate opinion by Mr. Justice Douglas), which is the barest minimal with which Congress should treat Constitutional rights.

B. *The Suggestion That Allowance Would Subsidize a Constitutional Right States a Fallacious and Inexpert View*

Since in the present posture of the law, it may perhaps be argued here that there is no requirement that a Constitutional right be subsidized (although in connection with the Constitutional guarantee of the right to counsel, as Chief Judge Lumbard showed (Tr. 18), the law has been subject to much recent review), and because the Acting Solicitor General has intimated that allowance of the deduction may involve a subsidy, it is felt that it would be appropriate at this point to refute that notion by an analysis of the real economic effect of deductions for actual business expenses.

The Acting Solicitor General (though confessing doubts that Congress intended the disallowance of illegal payments (Pet. Br. p. 17), suggests that because the allowance might "increase the violator's chances of profiting from illegal conduct; . . . [and because] . . . it is difficult to believe that Congress . . . could have intended the federal treasury in effect to provide a part of the money for an illegal payment . . . .", this Court must choose between adding a penalty or subsidizing the illegal payments (Pet. Br. pp. 16, 17). The issue thus presented to the Court is drawn from a hypothetical statement of facts (Pet. Br. p. 15). It is sub-

mitted that the Acting Solicitor General's own hypothetical facts establish beyond any question that the government never pays any part of an illegal payment that is proximately related to a trade or business, and that the government will not pay any part of respondent's legal fees, which, concededly, are the proximate result of respondent's business.

The hypothetical facts drawn by the Acting Solicitor General are as follows:

A taxpayer sells merchandise for	$50,000.
He has paid for the merchandise	37,500.
His prime profit is	$12,500.
In order to make the sale, he was obliged to pay a bribe of	10,000.
His actual profit is	$ 2,500.
Tax liability, if expense deduction is disallowed (at 50% of $12,500.)	$ 6,250.
Tax liability, if expense deduction is allowed (at 50% of $2,500.)	1,250.
Difference	$ 5,000.

The fact that the Commissioner will extract a tax payment "... more than double his actual profit from the transaction ....", if the deduction is disallowed, is much too clearly visible to be overlooked. Consequently, the Acting Solicitor General correctly calls it a "penalty in proportion to the amount of the illegal expenditure and the taxpayer's

income tax bracket, rather than [to] the seriousness of the offense committed . . . . " (Pet. Br. p. 16).[19]

The Acting Solicitor General fails to specifically state, though it is just as evident from the facts, that if the tax is collected under authority of a tax on net income, the disallowance will result in an overcollection of $5,000. That amount, however, is precisely the amount that he also says the taxpayer's tax liability will be reduced should the deduction be allowed. There is obvious error in a contention that claims that the Treasury is making a refund when it refrains from an unlawful collection of a tax. In truth, the Acting Solicitor General has completely begged the determinative question: Is the $10,000. payment a cost of earning the profit? That is so, because there is neither authority nor justification anywhere in the tax law to collect a tax on a profit increased by the cost of making that profit. Surely, if the $10,000. payment were salary to a salesman, the Acting Solicitor General would not be contending that the federal treasury had paid it.

The Acting Solicitor General overlooks that allowance of a deduction puts nothing into a taxpayer's pocket; he has been obliged to make the expenditure before he could earn the profit that the government taxes. As the hypothetical facts clearly show, disallowance adds the tax to the expense. In fact, if the expense is disallowed, the government will

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[19] The Solicitor General does not, however, suggest what authority there would be in the tax law for its use as a punishment for violation of law, even if the Court should devise a formula for making the punishment, after addition of the tax penalty, equal to the seriousness of the offense.

Neither does he suggest any authority for the use of the federal tax law as an instrument for punishment of violations of state law.

profit from the illegality because it has demanded more than its tax share only because the payment was illegal.

Moreover, by the very mechanics of the method of computing tax liabilities, the disallowance of an actually incurred business expense results in the creation of fictitious income.[20] (Real income can result only when the deduction is disallowed because not spent.) The basic error in equating the allowance of a deduction with a tax subsidy lies in the overlooking of the lack of reality in the "income" "created" by disallowance of an actual business expense.

The disallowance does not return to the taxpayer a single real penny of the money he had to actually pay someone to earn his profit. The "income" figure arrived at by disallowance of the deduction merely attributes money to the taxpayer which he does not really possess. Since the "income" is not real, even when "created" by the disallowance, it could not have been real before it was created, and it cannot be that the Treasury paid anything real when it was left uncreated.

The government's position, when it acquiesces in the deduction of an actually incurred business expense is no more than a neutral one,[21] neither giving nor taking. It gives

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[20] Taxable income is equally increased either by the addition of income or by the disallowance of expenses.

[21] In the consideration of the Bill that became the Revenue Act of 1964 (78 Stat. 19), Congress gave consideration to elimination of deductions for payment of state property and income taxes, and sales taxes. The elimination of these deductions would have had comparable effect to that of the disallowance of business expenses, since they would have increased taxable income by reason on non-recognition of payments, actually made. Congress decided against the proposal, because "[a] failure to provide deductions . . . could mean a combined burden of income taxes which in some cases would be extremely heavy. . . ." The Committee also said

only when it allows an expense, not incurred, or allows it in an amount greater than its reality. Similarly it takes only when it refuses to allow an expense that has been made, or allows it in an amount less than it has been made.

Taxes are practical matters that deal with economic facts. Income is income only when real and a payment is such only when something of value has been transferred. The illegality of a payment or the relation of a payment to illegality does not change any economic fact surrounding or arising from that payment.

C. *The Commissioner's Rule Results Not Only in the Imposition of a Severe Penalty for Failure in the Defense Against Criminal Charges, But Also Exerts Massive Pressure Against a Choice to Defend Against Such Charges*

A determination of the extent of the economic handicap that is imposed on the right to counsel by a disallowance of the cost of such counsel necessarily requires that the effect of the disallowance on real dollar-and-cents income be measured. That is so because the statutory definition of taxable income (formerly [statutory] net income) is no more than a reflection of real income. Real income exists as a fact quite unaffected by any Congressional definition.

The sole function of taxable income is to supply a base for taxation. The tax is computed by application of grad-

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it was "important for the Federal government to remain *neutral* as to the relative use made of these three forms of State and local taxation. . . ." (Emphasis added) (H. R. Rep. No. 749, 88th Cong., 1st Sess. (1963); S. Rep. No. 830, 88th Cong. 2nd Sess. p. 54 (1964).

It is clear that Congress had no idea that it was paying a part of the taxes to the states and local governments. On the contrary, it recognized that by permitting the deductions for tax payments actually made, it was standing aloof—doing nothing. Congress called that position "neutral".

uated percentage rates to that base, but since the tax must be paid in real dollars, the effective rate of taxation is not a percentage of taxable income, but rather a percentage of real income.

The tax law is designed to take a share of a taxpayer's income and to leave a balance for him to save or to spend as he wishes. Since the amount of the tax is determined by the combined effect of deductions, credits, and the tax-rates, the percentage of the tax-bite out of real income is similarly effected by that same combination. Hence, a change in any one of the three is equally capable of effecting a change in the effective rate of taxation.

When the tax law departs from economic reality by permitting the taxpayer to deduct as an expense an amount that is in excess of reality, or which has no basis in reality, taxable income is falsely reduced below real income. Therefore, the variation thus effected results in real income excused from tax. Such income consequently does not stand any tax cost and it is available for the taxpayer's personal use unreduced by any tax payment. (Good examples are deductions allowed in amounts other than at cost; viz., deductions for charitable contributions, the percentage depletion allowance for oil properties.)

However, when the tax law falsely inflates taxable income by refusing to allow an actual expenditure or by allowing it in an amount below reality, taxable income is increased by a fictitious amount which nevertheless produces a real tax. (For example: No loss on transactions between certain related persons is allowable, even when bona fide; the limited deduction for so-called non-business bad debts, though such loans were not made for personal reasons.) But, the government will not accept payment in fictitious

income. Therefore, the tax on such income must be paid out of income which does exist. Consequently, the taxpayer is required to dig into the balance which is rightfully his by reason of tax already paid. The tax cost on such fictitious income is therefore paid out of the already tax-paid share from other sources, and constitutes an additional tax burden on that share of income which the taxpayer, by right, should have free from tax.

The result is that the taxpayer loses the right to personal use with respect to the funds from the other sources that he has earned by payment of the tax. He loses the benefit for which he paid a tax, and to that extent the tax has been wasted. Those funds are paid as an additional tax penalty of a fictitious increase in income, and lost to the taxpayer. The tax cost of a personal expense however is merely the tax cost of making it available for personal use; it does not also pay a tax for its "creation".

The reduction of available funds resulting from the disallowance of real business expenses also produces a real economic dilemma, which is graphically illustrated by the Acting Solicitor General's hypothetical case.

Prime Profit	$12,500.
Tax, if he wins	1,250.
Tax, if he loses	6,250.

Hence, should he win, he was safe in spending the $10,000. for employment of counsel, because he will have a surplus for taxes. (In fact, he can spend the full $12,500 because he will not owe any taxes). However, should he lose, the expenditure of $10,000 for counsel fees will cost him an additional $5,000, for the payment of which he will have only $1,250. still available out of the transaction (assuming

he had not spent it). If that were the taxpayer's only business transaction, and if he had no other accumulated tax-paid funds, he would really be in trouble to find the additional $3,750. that the Commissioner would demand.

That is, indeed, a cruel dilemma with which to confront a taxpayer at the moment that he is charged with violation of a penal statute. Neither he, nor anyone else, can be sure whether our hypothetical taxpayer has $12,500, or $6,250. to spend for counsel fee in his defense.[22] That may make the difference in his defense.

Moreover, he cannot borrow against his tax liability, hoping to earn enough subsequently to pay it, because he must estimate and prepay his tax liability. Since underestimation subjects him to an additional penalty and willful underpayment is also a criminal offense (Int. Rev. Code of 1954, §7203), the taxpayer has no alternative but to choose his course of action in the crminal proceeding with cautious consideration for the severity of the tax consequences that will follow, should he be unsuccessful in his own defense.

The threat of the tax penalty follows him throughout his effort to obtain vindication. If, originally, he has gambled, using his funds to the maximum to pay for his defense, and he loses, his tax debt to the Treasury as a consequence, may be enough to bankrupt him and to impoverish his family. Yet, he must gamble again, if he seeks an appeal. The tax penalty follows him as additional punishment for losing in every step of his fight for vindication.

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[22] The Tax Court has gone so far as to say that when the taxpayer appeals the verdict, the determination of deductibility is suspended until the appeal is decided. *Joseph Cohen,* 2 CCH Tax Ct. Mem. 602 (1943).

The omnipresence of the tax penalty is no different than would be that of the tax collector's continuous presence at the side of the taxpayer, when he pleads or decides on an appeal, warning him that he defends at the risk of a tax penalty. It exerts massive pressure against a choice of putting up a defense. It destroys a taxpayer's freedom to defend himself. No civilized nation would subject an accused to pressure of that kind. It is an insult to Congress to say that Congress intended to exert that kind of pressure against a defendant's freedom to choose to defend himself.

The application of "overriding public policy" is analogous to the Commissioner forcing the taxpayer to place a side wager on the outcome of the trial, but a wager of such adverse consequence to the taxpayer that it has the power to force the taxpayer to decide not to take the risk. However, he cannot avoid that risk, unless he gives up his right to defend himself. It is a cruel doctrine, completely beneath the dignity of a great government.

CONCLUSION

The decision and judgment of the Court below should be affirmed.

Respectfully submitted,

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APPENDIX

Chronology of Decisions Relating to Disallowance of Counsel Fees

1924	Board of Tax Appeals	*Sara Backer,* 1 B. T. A. 214: first expression of public policy doctrine; deduction in case of *successful* criminal defense disallowed.
1925	Board of Tax Appeals	*Norvin R. Lindheim,* 2 B. T. A. 229: to same effect, citing *Sara Backer.*
1929	Board of Tax Appeals	*Burroughs Bldg. Material Co.,* 18 B. T. A. 101: public policy doctrine upheld; Sternhagen dissenting.
1930	Board of Tax Appeals	*B. E. Levinstein,* 19 B. T. A. 99: deduction disallowed, citing *Burroughs.*
1930	Board of Tax Appeals	*Sanitary Earthenware Specialty Co.,* 19 B. T. A. 641: deduction disallowed on grounds of stare decisis.
1930	Board of Tax Appeals	*John W. Thompson's Estate,* 21 B. T. A. 568, *appeal dismissed, 62 F. 2d 1082:* deduction disallowed on grounds of stare decisis.
1931	Second Circuit	*Burroughs Bldg. Material Co.* v. *Commissioner,* 47 F. 2d 178: Tax Court affirmed.
1937	Second Circuit	*National Outdoor Advertising Bureau* v. *Helvering,* 89 F. 2d 878: deduction disallowed.

1943	Board of Tax Appeals	*S. B. Heininger,* 47 B. T. A. 95: deduction disallowed on grounds of stare decisis.
1943	Seventh Circuit	*Heininger* v. *Commissioner,* 133 F. 2d 567: B. T. A. reversed; deduction for counsel fees in unsuccessful defense in administrative proceeding allowed—public policy doctrine rejected.
1943	Eighth Circuit	*Helvering* v. *Superior Wines & Liquors, Inc.,* 134 F. 2d 373: deduction for attorney's fees in case of settlement under penal statute disallowed.
1943	Supreme Court	*Commissioner* v. *Heininger,* 320 U. S. 467: alleged conflict among circuits settled in favor of Seventh Circuit; deduction in case of administrative proceeding allowed and public policy doctrine rejected.
1944	Tax Court	*Longhorn Portland Cement Company,* 3 T. C. 310: deduction for counsel fees in case of state antitrust action which was compromised *held,* allowed, citing *Heininger.*
1944	Commissioner	1944 CUM. BULL. p. 43: acquiescence in *Texas Longhorn* (as to legal fees; non-acquiescence as to fines.)
1944	Commissioner	G. C. M. 24377: counsel fees in unsuccessful antitrust defense ruled to be deductible.

1944 to 1956		Deductibility of counsel fees in unsuccessful criminal defense and inapplicability of public policy doctrine remain settled law for 12 years.
1954	Congress	1954 recodification: leaves language of I. R. C. §23a unchanged in §162 of the 1954 Code, thus indicating approval of G. C. M. 24377 and of rule that counsel fees in unsuccessful criminal defense may be deducted.
1956	Tax Court[1]	*Thomas A. Joseph,* 26 T. C. 562: public policy doctrine as applied to counsel fees revived; deduction disallowed; for first time it is suggested that *Heininger* rule applies only to administrative determinations.
1962	Commissioner	Revenue Ruling 62-175 (1962-2 CUM. BULL. 50); reverses G. C. M. 24377.
1964	Second Circuit	*Tellier* v. *Commissioner*: counsel fees in unsuccessful criminal defense held deductible, overruling *Burroughs.*

[1] *Anthony Cornero Stralla,* 9 T. C. 801 (1947), which dealt with the deductibility of lawful expenses of an unlawful business is omitted as irrelevant in this chronology. See *supra* p. 11, fn. 3. The various circuit court decisions discussed at *supra* pp. 12-16 are similarly omitted as they dealt with particular questions of fact not at issue here and do not relate to the subject of this chronology, which is the history of the specific rule that counsel fees are nondeductible as a matter of public policy in every case in which a criminal defense proves unsuccessful.

In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 351

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WALTER F. TELLIER AND EVELYN H. TELLIER

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE PETITIONER

1. Respondent challenges (Br. 8–20) the government's statement that the Commissioner's position in the instant case is supported by 40 years of uniform administrative practice and judicial decisions. Respondent concedes that from 1924 to 1944 and, again, from 1956 on the Commissioner and the courts consistently disallowed deductions such as those here in question. Respondent argues, however, that in 1944 both the Commissioner and the Tax Court abandoned their earlier position and that it was not until 1956 that they reinstated their earlier policy of disallowing such expenses. His claim is that *Longhorn Portland Cement Co.* v. *Commissioner,* 3 T.C. 310 (1944) and G.C.M. 24377, 1944 Cum. Bull. 93, show that the

203-168—66

Tax Court and the Commissioner "abandoned" their prior consistent policy of disallowance (Br. 12). We disagree.

It is clear that neither *Longhorn* nor G.C.M. 24377 constituted a reversal of the well established general rule of non-deductibility. At most they represented a very limited exception to the general rule—one relating only to the expenses of defending against an antitrust prosecution.[1] The limited antitrust exception was revoked by the Commissioner in 1962. Rev. Rul. 62–175, 1962–2 Cum. Bull. 50. It is manifest from the many cases decided between 1944 and 1956 that, with the sole exception of antitrust suits, the general rule of non-deductibility was consistently applied.

In 1945—one year after respondent claims that the Commissioner and the Tax Court had "abandoned" the general rule of non-deductibility—the Tax Court decided *Greene Motor Co.* v. *Commissioner,* 5 T.C. 314. While the court allowed the disputed deduction, it did so only because the attorney's fees there in question were incurred in arranging a settlement of potential civil and criminal liabilities. In reaching this result, the court recognized that such expenses would have been non-deductible if "the defense was unsuccessful and conviction followed" (p. 319). The court thought this general rule so well-established that "Citation of such cases is considered

[1] In fact, *Longhorn* related to an antitrust suit brought by the State of Texas which had been settled without conviction. Thus only G.C.M. 24377 concerned expenses of unsuccessfully defending an antitrust prosecution.

unnecessary here" (*ibid.*). However, the court declined to apply the rule where there had been "compromise" instead of "conviction" (p. 320, 321, 322).

Two years later in *Stralla* v. *Commissioner,* 9 T.C. 801, 821 (1947), the court specifically denied a deduction for attorney's fees connected with the unlawful operation of a gambling ship on the ground that "allowance of the deductions here claimed would * * * frustrate sharply defined * * * [State] policies." See, also, *Thomas* v. *Commissioner,* 16 T.C. 1417 (1951), and *Schwartz* v. *Commissioner,* 22 T.C. 717 (1054), affirmed, 232 F. 2d 94 (C.A. 5).[2]

Respondent cites (Br. 11, 12) the case of *Joseph* v. *Commissioner,* 26 T.C. 562 (1956) and Rev. Rul. 62–175, 1962–2 Cum. Bull. 50, as marking the "revival" by the Tax Court and the Commissioner of the general rule disallowing fees incurred in unsuccessfully defending a criminal prosecution. As the Tax Court's opinion in that case discloses, the *Joseph* case is merely one of the unbroken line of cases, both before and after 1944, applying the general rule of non-deductibility. The Tax Court opened its *Joseph* opinion with the statement that (p. 564) "We have held in a number of cases beginning as early as *Sarah Backer,* 1 B.T.A. 214 [1924], that legal expenses in-

[2] *Thomas* explicitly disallowed "attorneys' fees paid * * * in the unsuccessful defense of a criminal indictment." In *Schwartz* the court allowed a deduction for certain legal fees which had no connection with the criminal prosecution and noted that the taxpayer was not even claiming a deduction "for the fees of the attorney who handled the criminal trial" (22 T.C. at 721).

curred in the unsuccessful defense of a criminal prosecution are not deductible."

2. As explained in our opening brief, while the lower courts have disallowed deductions like those here in question on three grounds, the Commissioner is now placing reliance only on the public policy ground. Respondent answers (Br. 12) that since this Court's 1943 decision in *Commissioner* v. *Heininger,* 320 U.S. 467, "no court" has supported disallowance of attorney's fees on grounds of "overriding public policy." This is plainly incorrect.

In *Thomas* v. *Commissioner,* 16 T.C. 1417 (1951), the court explicitly denied a deduction for attorney's fees because, *inter alia,* "allowance of a deduction would be against public policy" (p. 1418). And in *Stralla* v. *Commissioner,* 9 T.C. 801 (1947), the court stated that "allowance of the deductions [for attorneys' fees] here claimed would be in our opinion 'to frustrate sharply defined * * * [State] policies'" (p. 821).[5]

Nor have the courts of appeals ceased to rely upon that ground. In the recent case of *Bell* v. *Commissioner,* 320 F. 2d 953, 956 (C.A. 8 1963), the court denied a deduction for attorneys' fees incurred in connection with taxpayer's criminal conviction, stating that one of the "[g]rounds for denial of deductibility

[5] As explained *supra* pp. 2–3, the court in *Greene Motor Co.* v. *Commissioner,* 5 T.C. 314 (1945), allowed a deduction for attorneys' fees only because they were incurred in connection with a "compromise" of potential civil and criminal liabilities rather than a "conviction," and thus, allowing a tax deduction would "involve no frustration of any public policy."

[is] * * * that to allow as a deduction the expenses incurred in unsuccessfully defending a criminal prosecution would violate public policy." Other recent appellate decisions dealing with attorneys' fees state the general rule of non-deductibility and cite in support cases expressly resting on considerations of public policy. See, *e.g., Port* v. *United States,* 163 F. Supp. 645, 647 (Ct. Cl. 1958), and *Hopkins* v. *Commissioner,* 271 F. 2d 166, 167–168 (C.A. 6 1959), citing *Burroughs Building Material Co.* v. *Commissioner,* 47 F. 2d 178, 180 (C.A. 2) (such fees disallowed "on grounds of public policy"), and *Thomas* v. *Commissioner,* 16 T.C. 1417, 1418 ("The allowance of a deduction [for such fees] would be against public policy."). See also *Jerry Rossman Corp* v. *Commissioner,* 175 F. 2d 711, 713 (C.A. 2 1949).

Respectfully submitted.

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JANUARY 1966.

U.S. GOVERNMENT PRINTING OFFICE: 1966

SUPREME COURT OF THE UNITED STATES

No. 351.—October Term, 1965.

Commissioner of Internal Revenue, Petitioner, *v.* Walter F. Tellier et ux.	On Writ of Certiorari to the United States Court of Appeals for the Second Circuit.

[March 24, 1966.]

Mr. Justice Stewart delivered the opinion of the Court.

The question presented in this case is whether expenses incurred by a taxpayer in the unsuccessful defense of a criminal prosecution may qualify for deduction from taxable income under § 162 (a) of the Internal Revenue Code of 1954, which allows a deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ."[1] The respondent, Walter F. Tellier, was engaged in the business of underwriting the public sale of stock offerings and purchasing securities for resale to customers. In 1956 he was brought to trial upon a 36-count indictment that charged him with violating the fraud section of the Securities Act of 1933[2] and the mail fraud statute,[3] and with conspiring to violate those statutes.[4] He was found guilty on all counts and was sentenced to pay an $18,000 fine and to serve four and a half years in prison. The judgment of conviction was affirmed on appeal.[5] In his unsuccessful defense of this criminal

[1] "(a) In general.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ." 26 U. S. C. § 162.

[2] 48 Stat. 84, as amended, 15 U. S. C. § 77q (a).

[3] 18 U. S. C. § 1341.

[4] 18 U. S. C. § 371.

[5] *United States* v. *Tellier*, 255 F. 2d 441 (C. A. 2d Cir.)

prosecution, the respondent incurred and paid $22,964.20 in legal expenses in 1956. He claimed a deduction for that amount on his federal income tax return for that year. The Commissioner disallowed the deduction and was sustained by the Tax Court. T. C. Memo. 1963–212, 22 CCH Tax Ct. Memo. 1062. The Court of Appeals for the Second Circuit reversed in a unanimous *en banc* decision, 342 F. 2d 690, and we granted certiorari. 382 U. S. 808. We affirm the judgment of the Court of Appeals.

There can be no serious question that the payments deducted by the respondent were expenses of his securities business under the decisions of this Court, and the Commissioner does not contend otherwise. In *United States* v. *Gilmore*, 372 U. S. 39, we held that "the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was 'business' or 'personal'" within the meaning of § 162 (a).' 372 U. S., at 49. Cf. *Kornhauser* v. *United States*, 276 U. S. 145, 153; *Deputy* v. *duPont*, 308 U. S. 488, 494, 496. The criminal charges against the respondent found their source in his business activities as a securities dealer. The respondent's legal fees, paid in defense against those charges, therefore clearly qualify under *Gilmore* as "expenses paid or incurred . . . in carrying on any trade or business" within the meaning of § 162 (a).

The Commissioner also concedes that the respondent's legal expenses were "ordinary" and "necessary" expenses within the meaning of § 162 (a). Our decisions have consistently construed the term "necessary" as imposing only the minimal requirement that the expense be "appropriate and helpful" for "the development of the [taxpayer's] business." *Welch* v. *Helvering*, 290 U. S.

111, 113. Cf. *Kornhauser* v. *United States, supra,* at 152; *Lilly* v. *Commissioner,* 343 U. S. 90, 93–94; *Commissioner* v. *Heininger,* 320 U. S. 467, 471; *McCullough* v. *Maryland,* 4 Wheat. 316, 413–415. The principal function of the term "ordinary" in § 162 (a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset. *Welch* v. *Helvering, supra,* at 113–116.[6] The legal expenses deducted by the respondent were not capital expenditures. They were incurred in his defense against charges of past criminal conduct, not in the acquisition of a capital asset. Our decisions establish that counsel fees comparable to those here involved are ordinary business expenses, even though a "lawsuit affecting the safety of a business may happen once in a lifetime." *Welch* v. *Helvering, supra,* at 114. *Kornhauser* v. *United States, supra,* at 152–153; cf. *Trust of Bingham* v. *Commissioner,* 325 U. S. 365, 376.[7]

It is therefore clear that the respondent's legal fees were deductible under § 162 (a) if the provisions of that section are to be given their normal effect in this case. The Commissioner and the Tax Court determined, however, that even though the expenditures meet the literal requirements of § 162 (a), their deduction must nevertheless be disallowed on the ground of public policy. That view finds considerable support in other adminis-

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[6] See Griswold, An Argument Against the Doctrine that Deductions Should Be Narrowly Construed as a Matter of Legislative Grace, 56 Harv. L. Rev. 1142, 1145; Wolfman, Professors and the "Ordinary and Necessary" Business Expense, 112 U. Pa. L. Rev. 1089, 1111–1112.

[7] See Brookes, Litigation Expenses and the Income Tax, 12 Tax L. Rev. 241.

trative and judicial decisions.[8] It finds no support, however, in any regulation or statute or in any decision of this Court, and we believe no such "public policy" exception to the plain provisions of § 162 (a) is warranted in the circumstances presented by this case.

We start with the proposition that the federal income tax is a tax on net income, not a sanction against wrongdoing. That principle has been firmly imbedded in the tax statute from the beginning. One familiar facet of the principle is the truism that the statute does not concern itself with the lawfulness of the income that it taxes. Income from a criminal enterprise is taxed at a rate no higher and no lower than income from more conventional sources. "[T]he fact that a business is unlawful [does not] exempt it from paying the taxes that if lawful it would have to pay." *United States* v. *Sullivan*, 274 U. S. 259, 263. See *James* v. *United States*, 366 U. S. 213.

With respect to deductions, the basic rule, with only a few limited and well-defined exceptions, is the same. During the Senate debate in 1913 on the bill that became the first modern income tax law, amendments were rejected that would have limited deductions for losses to

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[8] See *Sarah Backer*, 1 B. T. A. 214; *Norvin R. Lindheim*, 2 B. T. A. 229; *Thomas A. Joseph*, 26 T. C. 562; *Burroughs Bldg. Material Co.* v. *Commissioner*, 47 F. 2d 178 (C. A. 2d Cir.); *Commissioner* v. *Schwartz*, 232 F. 2d 94 (C. A. 5th Cir.); *Acker* v. *Commissioner*, 258 F. 2d 568 (C. A. 6th Cir.); *Bell* v. *Commissioner*, 320 F. 2d 953 (C. A. 8th Cir.); *Peckham* v. *Commissioner*, 327 F. 2d 855, 856 (C. A. 4th Cir.); *Port* v. *United States*, 163 F. Supp. 645 (Ct. Cl.). See also Note, Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning with the Internal Revenue Code, 72 Yale L. J. 108; 4 Mertens, Law of Federal Income Taxation, § 25.49 ff. Compare *Longhorn Portland Cement Co.*, 3 T. C. 310; G. C. M. 24377, 1944 C. B. 93; Lamont, Controversial Aspects of Ordinary and Necessary Business Expense, 42 Taxes 808, 833–834.

those incurred in a "legitimate" or "lawful" trade or business. Senator Williams, who was in charge of the bill, stated on the floor of the Senate that

> "[T]he object of this bill is to tax a man's net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures or losses. It is not to reform men's moral characters; that is not the object of the bill at all. The tax is not levied for the purpose of restraining people from betting on horse races or upon 'futures,' but the tax is framed for the purpose of making a man pay upon his net income, his actual profit during the year. The law does not care where he got it from, so far as the tax is concerned, although the law may very properly care in another way." 50 Cong. Rec. 3849.[9]

The application of this principle is reflected in several decisions of this Court. As recently as *Commissioner* v. *Sullivan*, 356 U. S. 27, we sustained the allowance of a deduction for rent and wages paid by the operators of a gambling enterprise, even though both the business itself and the specific rent and wage payments there in question were illegal under state law. In rejecting the Commissioner's contention that the illegality of the enterprise required disallowance of the deduction, we held that, were we to "enforce as federal policy the rule espoused by the Commissioner in this case, we would come close to making this type of business taxable on the basis of its gross receipts, while all other business would be taxable on the basis of net income. If that choice is to be made, Congress should do it." *Id.*,

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[9] In challenging the amendments, Senator Williams also stated: "In other words, you are going to count the man as having money which he has not got, because he has lost it in a way that you do not approve of." 50 Cong. Rec. 3850.

at 29. In *Lilly* v. *Commissioner*, 343 U. S. 90, the Court upheld deductions claimed by opticians for amounts paid to doctors who prescribed the eyeglasses that the opticians sold, although the Court was careful to disavow "approval of the business ethics or public policy involved in the payments . . . ." 343 U. S., at 97. And in *Commissioner* v. *Heininger*, 320 U. S. 467, a case akin to the one before us, the Court upheld deductions claimed by a dentist for lawyer's fees and other expenses incurred in unsuccessfully defending against an administrative fraud order issued by the Postmaster General.

Deduction of expenses falling within the general definition of § 162 (a) may, to be sure, be disallowed by specific legislation, since deductions "are a matter of grace and Congress can, of course, disallow them as it chooses." *Commissioner* v. *Sullivan*, 356 U. S., at 28.[10]

[10] Specific legislation denying deductions for payments that violate public policy is not unknown. *E. g.*, Internal Revenue Code of 1954, § 162 (c) (disallowance of deduction for payments to officials and employees of foreign countries in circumstances where the payments would be illegal if federal laws were applicable; cf. Treas. Reg. § 1.162–18); § 165 (d) (deduction for wagering losses limited to extent of wagering gains). See also Stabilization Act of 1942, § 5 (a), 56 Stat. 767, 50 U. S. C. A. Appendix § 965 (a), Defense Production Act of 1950, § 405 (a), as amended, c. 275, § 104 (i), 65 Stat. 136 (1951), 50 U. S. C. A. Appendix § 2105 (a), and Defense Production Act of 1950, § 405 (b), 64 Stat. 807, 50 U. S. C. A. Appendix § 2105 (b) (general authority in President to prescribe extent to which payments violating price and wage regulations should be disregarded by government agencies, including the Internal Revenue Service; see Rev. Rul. 56–180, 1956–1 C. B. 94). Cf. Treas. Reg. § 1.162–1 (a), which provides that "Penalty payments with respect to Federal taxes, whether on account of negligence, delinquency, or fraud, are not deductible from gross income"; Joint Committe on Internal Revenue Taxation, Staff Study of Income Tax Treatment of Treble Damage Payments under the Antitrust Laws, Nov. 1, 1965, p. 16 (proposal that § 162 be amended to deny deductions for certain fines, penalties, treble damage payments, bribes, and kickbacks).

The Court has also given effect to a precise and long-standing Treasury Regulation prohibiting the deduction of a specified category of expenditures; an example is lobbying expenses, whose nondeductibility was supported by considerations not here present. *Textile Mills Corp.* v. *Commissioner*, 314 U. S. 326; *Cammarano* v. *United States*, 358 U. S. 498. But where Congress has been wholly silent, it is only in extremely limited circumstances that the Court has countenanced exceptions to the general principle reflected in the *Sullivan*, *Lilly* and *Heininger* decisions. Only where the allowance of a deduction would "frustrate sharply defined national or state policies proscribing particular forms of conduct" have we upheld its disallowance. *Commissioner* v. *Heininger*, 320 U. S., at 473. Further, the "policies frustrated must be national or state policies evidenced by some *governmental* declaration of them." *Lilly* v. *Commissioner*, 343 U. S., at 97. (Emphasis added.) Finally, the "test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction." *Tank Truck Rentals* v. *Commissioner*, 356 U. S. 30, 35. In that case, as in *Hoover Express Co.* v. *United States*, 356 U. S. 38, we upheld the disallowance of deductions claimed by taxpayers for fines and penalties imposed upon them for violating state penal statutes; to allow a deduction in those circumstances would have directly and substantially diluted the actual punishment imposed.

The present case falls far outside that sharply limited and carefully defined category. No public policy is offended when a man faced with serious criminal charges employs a lawyer to help in his defense. That is not "proscribed conduct." It is his constitutional right. *Chandler* v. *Fretag*, 348 U. S. 3. See *Gideon* v. *Wainwright*, 372 U. S. 335. In an adversary system of criminal justice, it is a basic of our public policy that a

defendant in a criminal case have counsel to represent him.

Congress has authorized the imposition of severe punishment upon those found guilty of the serious criminal offenses with which the respondent was charged and of which he was convicted. But we can find no warrant for attaching to that punishment an additional financial burden that Congress has neither expressly nor implicitly directed.[11] To deny a deduction for expenses incurred in the unsuccessful defense of a criminal prosecution would impose such a burden in a measure dependent not on the seriousness of the offense or the actual sentence imposed by the court, but on the cost of the defense and the defendant's particular tax bracket. We decline to distort the income tax laws to serve a purpose for which they were neither intended nor designed by Congress.

The judgment is

Affirmed.

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[11] Cf. Paul, The Use of Public Policy by the Commissioner in Disallowing Deductions, Proc. Tax Inst. Univ. S. Calif. School of Law 715, 730–731: ". . . Section 23 (a)(1)(A) [the predecessor of § 162 (a)] is not an essay in morality designed to encourage virtue and discourage sin. It 'was not contrived as an arm of the law to enforce State criminal statutes. . . .' Nor was it contrived to implement the various regulatory statutes which Congress has from time to time enacted. The provision is more modestly concerned with 'commercial net income'—a businessman's net accretion in wealth during the taxable year after due allowance for the operating costs of the business. . . . There is no evidence in the Section of an attempt to punish taxpayers . . . when the Commissioner feels that a state or federal statute has been flouted. The statute hardly operates 'in a vacuum,' if it serves its own vital function and leaves other problems to other statutes."